

China State Commercial Banks' Non-Performing Loans: Workout and Prevention

JIANBO LOU

A thesis submitted for the degree of Doctor of Philosophy of
the University of London
in satisfaction of the requirements of the Ph.D. examination

Centre for Commercial Law Studies
Queen Mary and Westfield College
University of London

February 2001

Abstract

The purpose of this thesis is to examine the very significant problem of State bank non-performing loan (NPL) in China. NPLs undermine the stability of China's banking system and the efficient operation of its markets. This thesis will make recommendations for developing better workout procedures to deal with existing NPLs and explore the role of banking regulation and supervision in NPL prevention, as well as in avoiding impacts of NPLs on the stability of banking system, drawing on experiences at national, regional and international levels.

The accumulation of NPLs in China has been caused by the dominant role of State banks in China's financial markets, policy loans to state owned enterprises (SOEs), unnecessary administrative controls on banks' lending activities, weak internal controls within State banks and inappropriate banking regulation and supervision. All these have seriously ruined the conditions of market discipline in China and resulted not only in large amount of NPL stock, but also the constant creation of new NPLs on State banks' balance sheets.

The NPL problem in China is not limited to individual banks. It is a systemic problem closely connected to the SOE problem. The existing bank NPLs cannot be worked out without debt and enterprise restructuring. The balance sheets of banks and firms must be cleaned up by, first, recapitalizing banks to write off and make provision for existing NPLs, and, second, setting up independent asset management companies to purchase and manage bank NPLs.

To prevent the increasing accumulation of new NPLs, unnecessary administrative controls on banks must be removed; prudential banking regulation and supervision must be enhanced; appropriate internal control systems must be promoted within banks, especially with regard to the proper risk evaluation systems and internal decision-taking structures. To avoid the damaging impacts of NPL problem on the stability of the banking system, an explicit limited deposit insurance system should be introduced; the central bank's lender of last resort facilities must be properly defined; bank insolvency resolution mechanisms must be put in place. In a word, the proper functioning of market discipline must be restored in China.

Acknowledgement

I am deeply grateful to Prof. Joseph J. Norton, Sir John Lubbock Professor of Banking Law at the CCLS, the University of London and Dr. George Walker, Lecturer at the CCLS, the University of London, who are both my supervisors. Without their extensive supervision and constant encouragement, this thesis would not have been completed.

Thanks should also be given to Dr. Zhongfei Zhou, Sir John Lubbock Support Fund Fellow, CCLS; Professor Frank Lin and Dr. Jay J. Lin at the National Chenchi University of Taiwan; and Mr. Yangxin Wang, General Manager of International Department, the Bank of China, for their enlightening suggestions on my thesis. Special gratitude should be expressed to Mr. Douglas Arner, now Assistant Professor at the Hong Kong University Law Faculty, and Jorge Guira, J. Hoogmar, Heba Shams and Mamilo Yokoi at CCLS. They kindly edited the thesis for me. My sincere thanks are also extended to all other members of our London-based team who have created a very friendly environment for working together. They are Parmjit Badeshia, Wallace Wang and Paul, Liang.

I also would like to thank all my friends in London for taking care of me when I was recovering from the road accident in 1998. Financial support from the Ministry of Education, the PRC and the K. C. Wong Education Foundation (Hong Kong) is greatly acknowledged.

Last but not least, I want to thank Dean Wu, Zhipan and my other colleagues at Peking University Law School for their helping me and facilitating my research in China. Without their support, it would have been impossible for me to accomplish what I have achieved.

China State Commercial Banks' Non-Performing Loans: Workout and Prevention

TABLE OF CONTENTS

ABSTRACT

ACKNOWLEDGEMENT

ABBREVIATION

INTRODUCTION

- I. BACKGROUND: THE PROBLEM STATED**
- II. STRUCTURE OF THE VOLUME**
- III. METHODOLOGIES**
 - A. GENERALIZATION VS. SPECIALIZATION**
 - B. ECONOMIC ANALYSIS VS. LEGAL ANALYSIS**

Chapter One:

**CHIAN'S BANK NON-PERFORMING LOAN PROBLEM: SERIOUSNESS, CAUSES
AND SOLUTION**

- I. INTRODUCTION**
- II. THE SERIOUSNESS OF THE BANK NPL PROBLEM IN CHINA**
 - A. THE SERIOUSNESS: LARGE AMOUNT OF EXISTING NPLS AND INCREASING NEW
NPLS**

B. NEGATIVE EFFECTS OF STATE BANK NPLS

1. Negative Effects on State Banks

- (i) *The decreasing profitability of the “big four”*
- (ii) *The Deteriorating Creditworthiness of State Commercial Banks*
- (iii) *The Potential Failure of State Commercial Banks and the Entire Banking System*

2. Negative Effects on the country’s Economic Reform and Its Real Economy Growth

- (i) *Negative Effects on the Economic Reform towards a Market Economy*
- (ii) *Negative Effects on the Real Economy*

C. SUMMARY

III. CAUSES OF BANK NPLS — THE THEORETICAL FRAMEWORK

A. SOFT BUDGET CONSTRAINTS

- 1. The Concept of Soft Budget Constraints and Its Application
- 2. Consequences of Soft Budget Constraints
- 3. Sources of Soft Budget Constraints

B. MARKET DISCIPLINE — A MECHANISM TO CURB SOFT CREDIT

- 1. General Introduction — the Theory of Market Discipline
- 2. Market Discipline as a Mechanism to Curb Unsustainable Borrowing and Its Conditions

C. FAILURE OF MARKET DISCIPLINE — THE ULTIMATE ROOT OF THE NPL PROBLEM IN CHINA

IV. CAUSES OF BANK NPLS — EMPIRICAL ANALYSES

A. BANK-CENTRIC AND STATE-BANK-DOMINATED FINANCIAL SYSTEM

1. The Bank-Centric Finance in China

- (i) *Underdeveloped Capital Markets*
- (ii) *The Domination of Bank Lending in Enterprise Finance*
- (iii) *The Domination of Bank Deposit Savings in Household Financial Assets*

(iv) *High-Leverage Ratio in Enterprises and High-Level of NPLs — a Direct Consequence of the Bank-Centric Finance*

2. The Domination of State Commercial Banks

(i) *The “Big Four”-dominated Financial System*

(ii) *State Commercial Bank-domination: Captive Finance Markets*

B. SOFT BUDGET CONSTRAINTS ON SOES IN THE FORM OF POLICY LOANS

1. General Introduction

2. Policy Loans for Development Purpose

3. Policy Loans to Subsidize Loss-making SOEs

4. Failure of Market Discipline Due to Policy Loans

C. ADMINISTRATIVE CONTROLS ON STATE COMMERCIAL BANKS

1. Administrative Controls on State Commercial Banks as Monetary Policy Instruments

2. The Credit Plan

(i) *General Introduction*

(ii) *Negative Effects of the Credit Plan*

3. Interest Rate Controls

(i) *The Development of Interest Rate Controls*

(ii) *The Negative Effects of Interest Rate Control*

4. Division of Business Scope among State Specialized Banks

(i) *The Development of Business Scope Division among State Specialized Banks*

(ii) *The Negative Effects of the Business Division*

D. WEAK INTERNAL CONTROL SYSTEMS IN STATE COMMERCIAL BANKS

E. THE INAPPROPRIATE BANKING REGULATION AND SUPERVISION

F. SUMMARY

V. THREE BASIC STRATEGIES TO DEAL WITH BANK NPL PROBLEM

A. BANK CLOSURE AND LIQUIDATION AT LARGE SCALE

B. REGULATORY FORBEARANCE

1. Regulatory Forbearance General

2. Regulatory Forbearance in China: a Failed Policy
- C. BANK RESTRUCTURING
 1. Justification for Bank Restructuring
 2. Ten Critical Points in Managing and Resolving a Systemic Bank Crisis and Their Implication for China
- D. SUMMARY
- V. CONCLUSION

Chapter Two:

NON-PERFORMING LOAN WORKOUTS: BANK RECAPITALIZATION, AMC PRACTICES AND NPL MANAGEMENT

- I. INTRODUCTION
- II. RECAPITALIZING THE “BIG FOUR”
 - A. JUSTIFICATION FOR GOVERNMENT RECAPITALIZATION OF THE “BIG FOUR”
 1. State Ownership of the “Big Four”
 2. The Low Profitability of the “Big Four” Denotes That They Cannot Grow out of the Problem Themselves
 3. Difficulties for the “Big Four” to Raise Capital
 - B. RECAPITALIZING THE “BIG FOUR” — TECHNICAL CONSIDERATIONS
 1. Liability Side Vs. Asset Side Recapitalization
 2. Cash Injection Vs. Bond-Bad Debt Swap
 3. *Ex-ante* Recapitalization Vs. *Ex-post* Recapitalization
 4. Central Bank Vs. Treasury
 5. Summary
 - C. COMMENTS ON CHINA’S BANK RECAPITALIZATION PRACTICES
 1. The Special Treasury Bond Issuance in 1998
 2. The 1999 Practice
 - D. THE CONFLICTS BETWEEN RECAPITALIZATION AND MARKET DISCIPLINE
 1. Methods to Enhance Market Discipline: Asian Experience
 2. Implications for China
- III. CHINA’S AMC PROGRAM

- A. WHY ASSET MANAGEMENT COMPANIES IN CHINA?
 - 1. The Polish Experience: Leaving the NPLs inside the Banks
 - 2. Advantages and Disadvantages of the Specialized Agency Solution: the Experience of “Asian Crisis Countries”
 - 3. Implications for China
- B. CHINA’S AMC PROGRAM
- C. CHARACTERISTICS OF CHINA’S AMCS
 - 1. Bank-Specific AMCs
 - 2. State Ownership and Heavy Administrative Color
 - 3. Wide Business Scope and Powers
- D. PROBLEMS WITH CHINA’S AMC PROGRAM AND RECOMMENDED SOLUTION
 - 1. The Dilemma Faced by Chinese AMCs
 - 2. The Dependence of AMCs on the Respective Banks
 - 3. The Lack of Expertise and Experience
 - 4. Difficulties in Evaluating Assets
- E. IMMEDIATE LEGAL ISSUES RELATED TO CHINA’S AMC PROGRAM AND RECOMMENDED SOLUTION
 - 1. Immediate Legal Issues Related to AMC Practices in China
 - (i) *The Notification Obligation under the Contract Law*
 - (ii) *Procedural Requirements for the Transfer of Security Interests*
 - (iii) *AMCs’ Liabilities to Debtors*
 - 2. Recommended Solution
- IV. TWO MANAGEMENT STRATEGIES TOWARDS NPLS AND THEIR IMPLICATIONS FOR CHINA
 - A. TWO MANAGEMENT STRATEGIES TOWARD NPLS
 - B. CHOOSING THE RIGHT STRATEGY: EXPERIENCE OF MALAYSIA AND SOUTH KOREA
 - C. IMPLICATIONS FOR CHINA
- V. DEBT-EQUITY SWAPS
 - A. DEBT-EQUITY SWAPS: INTERNATIONAL EXPERIENCES
 - B. THE DEVELOPMENT OF DEBT-EQUITY SWAPS IN CHINA
 - 1. The SETC Debt-Equity Swap Scheme

2. The Implementation of the Scheme

C. POLICIES BEHIND THE SETC DEBT-EQUITY SWAP SCHEME

1. The Debt-Equity Swap Scheme as Part of the Government Anti-deflation Policies
2. The Micro-economic Effects: a Win-Win Situation for SOEs and Banks
3. Justification for Converting SOEs' Debts into Equity

D. PROBLEMS WITH THE CURRENT DEBT-EQUITY SWAP SCHEME AND RECOMMENDED SOLUTIONS

1. Moral Hazard Problem
2. Lack of Workable Reorganization Plan

E. AMCS' EXIT PROBLEM

1. The Importance of AMCs' Timely Exit
2. Probable Exit Routes for AMCs and Obstacles
 - (i) *Difficulties in Disposing Shareholdings by Selling Them to the Public*
 - (ii) *Difficulties in Selling Shares to Strategic Investors*
 - (iii) *Difficulties in Selling Back the Shares to the Debtor Companies or Their Parent Institutions*

F. SUMMARY

VI. A PROPER LEGAL INFRASTRUCTURE FOR DEBT DISPOAL AND RESTRUCTURING

A. CREDITOR PASSIVITY OF THE BANKS IN CHINA: THE LACK OF AN EFFICIENT LOAN COLLECTING MECHANISM IN CHINA

1. The Phenomena
2. The Causes
 - (i) *The Disincentive Factors Within China's Banking System*
 - a. Soft Budget Constraints on State Commercial Banks
 - b. Inadequate Loan Classification and Provisioning Rules
 - c. Lack of Autonomy in Loan Write-off
 - (ii) *Problems With China's Bankruptcy Legislation*
 - a. Problems with Bankruptcy Procedures
 - b. The Pro-employee Asset Distribution

3. Policy Recommendation

B. THE LACK OF CONSENSUAL MECHANISMS TO FACILITATE NEGOTIATION BETWEEN CREDITORS AND DEBTORS

1. The Conciliation and Reorganization Procedure Provided by the Enterprise Bankruptcy Law Cannot Fit the Need of Debt Restructuring

2. The Main Bank System in China — Should China Develop Bank-led Debt Restructuring?

3. Out-of-court Procedure

(i) *Who Should Take Responsibility for Corporate Sector Restructuring in China?*

(ii) *Collective Action Problem in Debt Restructuring*

(iii) *Pro-claim debts*

a. The Economics behind the Pro-claim Debt

b. The Closed-end Loan in China: Is it a Pro-Claim Debt?

(ii) SUMMARY

Chapter Three:

NON-PERFORMING LOAN PREVENTION — ENHANCING PRUDENTIAL REGULATION AND SUPERVISION, PROMOTING BANK INTERNAL CONTROL SYSTEMS

I. INTRODUCTION

II. REMOVING UNNECESSARY ADMINISTRATIVE CONTROLS ON STATE COMMERCIAL BANKS

A. INDIRECT MONETARY POLICY INSTRUMENTS VS. DIRECT MONETARY POLICY INSTRUMENTS

B. CREDIT GUIDANCE VS. CREDIT PLAN

1. The Removal of Credit Plan

2. The Introduction of Credit Guidance

3. The Implication of the Reform

C. DECONTROL OF INTEREST RATES

1. China's Current RMB Interest Rate Administration System under the 1999 Interest Rate Administration Provisions
2. Efforts towards the Liberalization of Interest Rates
 - (i) *Establishing and Improving the Floating Rate System*
 - (ii) *The Reform of Loan Interest Rate Categorizing and Calculation Measures*
3. Prospects of Interest Rate Liberalization in China

III. CURRENT BANKING REGULATION AND SUPERVISION IN CHINA: AS COMPARED WITH THE BASLE COMMITTEE CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

A. LICENSING PROCESS AND APPROVAL FOR CHANGES IN STRUCTURE

1. The Core Principles' Requirements
2. Licensing and Structure Change Approval in China
3. Are China's Requirements in Conformity with the Basle Core Principles?

B. ARRANGEMENTS FOR ONGOING BANKING SUPERVISION

1. Prudential Regulations and Requirements
2. Methods of Ongoing Banking Supervision
 - (i) *General Introduction*
 - (ii) *On-site Examination and Off-site Surveillance in China*
 - a. From Solely Relying on On-site Examination towards the Combination of On-site Examination and Off-site Surveillance
 - b. Establishing Standards for On-site Examination and Off-site Surveillance
 - c. Establishing and Improving the Reporting System
 - d. Consolidating On-going Supervision
 - (iii) *Problems with China's Ongoing Supervision and Recommended Solutions*
 - a. Developing Clear Rules for On-site Examination
 - b. Making Full Use of Independent External Auditors

- c. Developing Consultations between the PBOC and Bank Senior Management
 - d. Developing a Rating System Similar to the CAMEL System so as to Establish Early Warning Systems
 - C. SANCTIONING: FORMAL POWERS OF SUPERVISORS
 - 1. China Has Developed a Set of Supervisory Measures to Bring about Prompt Corrective Action (PCA)
 - 2. Problems with China's PCAs and Improvement Recommendations
- IV. PROMOTING INTERNAL CONTROL SYSTEMS WITHIN COMMERCIAL BANKS
 - A. THE BASLE COMMITTEE FRAMEWORK FOR INTERNAL CONTROL SYSTEMS IN BANKING ORGANIZATION
 - B. THE DEVELOPMENT OF BANK INTERNAL CONTROLS IN CHINA
 - 1. Bank Internal Controls before the Issuance of the PBOC Guidelines for Enhancing Internal Controls of Financial Institutions
 - 2. The 1997 PBOC Guidelines for Enhancing Internal Controls of Financial Institutions: in Comparison with the Basle Committee Internal Control Paper
 - (i) *Definition and Objectives of Internal Controls*
 - (ii) *Primary Elements of Internal Controls*
 - a. Management Oversight and the Control Culture
 - b. Risk Recognition and Assessment
 - c. Control Activities and Segregation of Duties
 - d. Information and Communication
 - e. Monitoring Activities and Correcting Deficiencies
 - (iii) *Evaluation of Internal Control Systems by Supervisory Authorities*
 - C. PROBLEMS WITH INTERNAL CONTROLS IN CHINA'S COMMERCIAL BANKS
 - 1. The Organizational Structure of State Commercial Banks
 - (i) *The Organizational Structure of State Commercial Banks*
 - (ii) *Diversifying the Ownership Structure of the "Big Four": a Solution to Their Corporate Governance Problem?*

2. The Information Problem

3. Prospects

V. SUMMARY

Chapter Four:

BANKING SAFETY NET: MECHANISMS FOR CRISIS MANAGEMENT

I. INTRODUCTION — DESIGNING A BANKING SAFETY NET

II. DEFINING THE LENDER-OF-LAST-RESORT IN CHINA

A. A GENERAL INTRODUCTION

1. Understanding the LOLR Properly

2. The History and Theoretical Foundation of the LOLR

3. Defining the LOLR in Practice

B. DEFINING THE PBOC'S LOLR ROLE

1. The PBOC's LOLR Role Is Not Well Defined in China

2. Legal Definition of the LOLR: the US, UK and Japan Models

(i) *The US Model*

(ii) *The UK Model*

(iii) *The Japan Model*

3. Implications for China

III. INTRODUCING A DEPOSIT INSURANCE SYSTEM INTO CHINA

A. WHY DEPOSIT INSURANCE?

1. A Brief Survey of Deposit Insurance Programs Worldwide

2. Pros and Cons of Deposit Insurance

3. Doctrine of Necessity

4. To Replace the Implicit Government Guarantee in China with
Explicit Deposit Insurance

(i) *China's Current Government Implicit Guarantee*

(ii) *Arguments for and against Government Implicit Guarantee*

(iii) *Conclusion: China Should Replace the Current
Government Implicit Guarantee with Explicit Deposit
Insurance*

B. ISSUES TO BE CONSIDERED AND PRINCIPLES TO BE FOLLOWED IN DESIGNING CHINA'S DEPOSIT INSURANCE SYSTEM

1. Issues to Be Considered

2. Principles for Designing a Deposit Insurance System

(i) *The Explicit Deposit Insurance Should Be Established by Legislation*

(ii) *The Deposit Insurance System Should Be Designed in as Incentive-compatible a Way as Possible*

(iii) *The Deposit Insurance System Should Be in Harmony with the Existing Financial System*

C. DESIGNING CHINA'S DEPOSIT INSURANCE SYSTEM

1. Organizational Structure, Coverage and Funding of Deposit Insurance

(i) *The Organizational Structure*

(ii) *The Scope of Deposit Insurance*

(iii) *The Deposit Insurance Coverage*

(iv) *Funding the Deposit Insurance*

2. Deposit Insurance Premiums

3. Membership of the Deposit Insurance System

4. Summary

D. TIMING THE INTRODUCTION OF DEPOSIT INSURANCE

IV. INSOLVENCY RESOLUTION

A. GENERAL INTRODUCTION

B. CLOSURE AND LIQUIDATION (DEPOSIT PAYOFF)

1. Out of Court Liquidation: Voluntary Closure Vs. Administrative Closure

(i) *Legal Infrastructure for Administrative Closure*

(ii) *Closure Procedures*

(iii) *Advantages and Disadvantages of the Administrative Closure*

2. Bankruptcy

(i) *Statutory Provisions*

(ii) *Problems Raised by the GITIC Case*

C. MERGER AND TAKE OVER (PURCHASE & ASSUMPTION)

1. General Introduction
2. The Chinese Practice

D. RESCUE PACKAGE OR OPEN BANK ASSISTANCE

1. General Introduction
2. Application in China

E. MANAGEMENT TAKEOVER (A VARIATION OF BRIDGE BANK)

1. The Bridge Bank Practice
2. Management Takeover in China

F. PROBLEMS WITH CHINA'S BANK INSOLVENCY RESOLUTION

1. The Uncertainty in Treating Foreign Creditors
2. The PBOC's Autonomy in Dealing with Problem Institutions
3. Inadequate Transparency and Disclosure

G. BUILDING UP A SOLID LEGAL INFRASTRUCTURE FOR BANK INSOLVENCY RESOLUTION

1. General Consideration: Should China Adopt Special Legislation on Bank Insolvency Resolution
2. Issues that Need to Be Clarified for Bank Insolvency Resolution in China
 - (i) *The Autonomy of the PBOC in Deciding Insolvency Resolution and Its Limitation*
 - (ii) *Elaborating Provisions on Administrative Closure*
 - (iii) *Rules on Bank Bankruptcy Must Be Established in More Details*

V. CONCLUSION

Chapter Five:

CONCLUDING OBSERVATIONS AND RECOMMENDATIONS FOR RESTORING MARKET DISCIPLINE IN CHINA

- I. INTRODUCTION
- II. THE FAILURE OF MARKET DISCIPLINE — THE ULTIMATE ROOT OF THE STATE COMMERCIAL BANK NPL PROBLEM
 - A. THE CAPTIVE FINANCIAL MARKETS
 - B. THE INFORMATION PROBLEM
 - C. THE BAILOUT EXPECTATION
 - D. THE IRRESPONSIBILITY TO MARKET SIGNALS BY BORROWERS
- III. SYSTEMATIC BANKING AND SOE RESTRUCTURING — STRATEGIES TOWARD THE BANK NPL PROBLEM IN CHINA
 - A. THE NECESSITY OF A COMPREHENSIVE BANK AND SOE RESTRUCTURING
 - B. KEY STEPS FOR BANK AND SOE RESTRUCTURING IN CHINA
- IV. RESOLVING THE STOCK OF NPL: BANK RECAPITALIZATION AND NPL MANAGEMENT
 - A. RECAPITALIZATION OF STATE COMMERCIAL BANKS VS. MARKET DISCIPLINE
 - 1. *Ex-ante* Recapitalization Vs. *Ex-post* Recapitalization
 - 2. Private Sector-based Solution & Conditioning Public Support
 - B. AMC PRACTICES IN CHINA: CAN AMCS IMPOSE MARKET DISCIPLINE ON SOES?
 - 1. Characteristics of AMCs in China
 - 2. The Debt-Equity Swap Scheme in China
 - 3. Problems with China's AMC Practices
 - (i) *The Dilemma Faced by Chinese AMCs*
 - (ii) *AMCs' Capacity and Incentive Problem*
 - (iii) *Moral Hazards Accompanying the Debt-Equity Swap Scheme*
 - 4. A Necessary Legal Framework for NPL Management in China
 - (i) *An AMC Law Should Be Adopted by the NPC or Its Standing Committee*
 - (ii) *Updating China's Banking and Bankruptcy Legislation so that Banks Will Have Incentives to Be Positive Creditors*
 - (iii) *Establishing An Appropriate Framework to Facilitate Negotiation between Creditors and Debtors*
 - 5. Conclusion

- V. NPL PREVENTION: DEVELOPING A PARTNERSHIP RELATIONSHIP BETWEEN BANKING REGULATION AND MARKET DISCIPLINE
 - A. WHY A PARTNERSHIP RELATIONSHIP BETWEEN BANKING REGULATION AND MARKET DISCIPLINE?
 - 1. Rationale of Regulation, Rationale of Market Discipline
 - 2. The Limitation of Regulation
 - 3. Conclusion
 - B. THE DEVELOPMENT OF PRUDENTIAL BANKING REGULATION IN CHINA AND ITS COMPATIBILITY WITH MARKET DISCIPLINE
 - 1. Fostering Competition Should Be One of the Objectives for Banking Regulation and Supervision in China
 - 2. Removing Administrative Controls on Banks Completely
 - 3. Promoting Disclosure Standards and Accounting Practices
- VI. DESIGNING AN APPROPRIATE BANKING SAFETY NET TO ENHANCE MARKET DISCIPLINE AND PRUDENTIAL REGULATION IN CHINA
 - A. THE OVERALL CONSISTENCY BETWEEN THE BANKING SAFETY NET AND MARKET DISCIPLINE
 - 1. The Inherent Moral Hazard Problem
 - 2. Understanding the Safety and Soundness Properly
 - B. THE BANK SAFETY NET MUST BE WELL-DESIGNED AND OPERATED
- VII. CONCLUDING REMARKS

TABLES AND FIGURES

Table 1.1: Profits Margin of Banks in China (percentage): 1995-1997

Table 1.2: Table of Enterprise Finance Structure in China

Figure 2-1: NPL Management Strategies

Table 4.1: Administrative Closure of Financial Institutions in China

ANNEX

BIBLIGORAPHY

ABBREVIATION

ABC, the Agricultural Bank of China

ABS, asset-backed securitization

ADB, Asian Development Bank

ADB, the Agricultural Development Bank (China)

AMC(s), Assets Management Corporation(s)

Basel Committee, Basle Committee on Banking Supervision

BCAs, bank-led conciliation agreements (Poland)

BCCI, Bank of Credit and Commerce International

BOC, the Bank of China (China)

BOCOM, the Bank of Communications (China)

BOE, the Bank of England (the UK)

CAB, China Association of Banks

CAMEL, Capital, Asset Quality, Management, Earnings and Liquidity

CARs, Capital Adequacy Requirements

CBI, central bank independence

CCB, China Construction Bank

CDRAC, the Corporate Debt Restructuring Advisory Committee (Thailand)

CDRC, the Corporate Debt Restructuring Committee (Malaysia)

CIB, China's Investment Bank

CIRC, China Insurance Regulatory Commission

CITIC, China International Trust and Investment Corp.

Core Principles, Basle Committee on Banking Supervision on Core Principles for Effective Banking Supervision

COSCO, China Ocean Shipping Company

CPC, the Communist Party of China

CPI, China People's Insurance Co.

CPIC, China Pacific Insurance Co. (China)

CRA, Corporate Restructuring Agreement (South Korea)

CSRC, China Securities Regulatory Commission

EBRP, the 1993 law on financial restructuring of enterprises and banks (Poland)

EC, European Community

FDIC, Federal Deposit Insurance Corporation (the US)
FDICIA, the 1991 Federal Deposit Insurance Corporation Improvement Act (the US)
FED, Board of Federal Reserve System of the United States
FHLBB, Federal Home Loan Bank Board (the US)
FIFI, foreign-invested financial institution (China)
FIRREA, the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (the US)
FRA, Financial Sector Restructuring Agency (Thailand)
FSA, Financial Service Authority (the UK)
FSC, Financial Supervisory Commission (South Korea)
FSLIC, Federal Savings and Loan Insurance Corporation (the US)
GATT, General Agreement on Tariff and Trade
GITIC, Guangdong International Trust and Investment Corporation
GZITIC, Guangzhou International Trust and Investment Corporation
HDB, the Hainan Development Bank (China)
HHKMTIC, Hainan Hong Kong & Macao Trust and Investment Company (China)
HKMA, Hong Kong Monetary Authority
IBRA, the Indonesia Bank Restructuring Agency (Indonesia)
ICBC, the Industrial and Commercial Bank of China
IMF, International Monetary Fund
INDRA, the Indonesia Debt Restructuring Agency
KAMCO, Korea Asset Management Corp. (South Korea)
KDIC, Korean Deposit Insurance Company (South Korea)
LOLR, lender of last resort
LTCB, the Long-Term Credit Bank of Japan
M & A, Merger and Acquisition
MAS, the Monetary Authority of Singapore
MOFTEC, Ministry of Foreign Trade and Economic Cooperation (China)
MOU, Memorandum of Understanding
MOUs, Memoranda of Understanding
NEAC, the National Economic Action Council (Malaysia)
NPC, the National People's Congress (China)
NPL(s), non-performing loan(s)
P & A, purchase and assumption

PBOC, the People's Bank of China

PCA, prompt corrective action

PCBC, People's Construction Bank of China (the predecessor of the CCB)

RTC, the Resolution Trust Corporation (the US)

SAFE, the State Administration of Foreign Exchange (China)

SDB, the State Development Bank (China)

SETC, the State Economic and Trade Commission (China)

SEZ(s), Special Economic Zone(s) (China)

SOE(s), State-owned Enterprise(s)

SOFIs, the state-owned financial institutions (China)

SPV(s), special purpose vehicle(s)

TB(s), transnational bank(s)

WTO, the World Trade Organization

INTRODUCTION

I. BACKGROUND: THE PROBLEM STATED

Non-performing loans (NPLs)¹ emerged in the People's Republic of China as early as 1958.² However, they were not perceived as a "problem" during the centrally-planned economy period (1950-1979), as the borrowers were State-operated enterprises and the lender was a State mono-bank. If the companies were not able to repay their debts, the State would help them in repaying their debts or would provide the bank with budgetary allowances to write-off the unpaid debts.³

It was not until the 1990s that NPLs became a visible and publicly discussed problem in China. In November 1993, the 3rd Plenum of the 14th National Congress of the Communist Party of China (CPC) set the future course for financial sector development in China as part of its "socialist market economy" strategy.⁴ Accordingly, the State Council adopted "Resolution on Financial System Reform" in the same year, drawing a blueprint for overhauling China's financial system, including the commercialization of State banks.⁵ It became recognized then that with huge amount of NPLs on their books, State banks could not become genuine commercial banks.

¹ The Basel Committee on Banking Supervision (Basle Committee) uses the term "impaired loans" in its *Sound Practices for Loan Accounting and Disclosure* (issued in July 1999). Loan "impairment", according to the Basel Committee, represents deterioration in the credit quality of one or more loans that it is probable that the bank will be unable to collect, or there is no longer reasonable assurance that the bank will collect, all amounts due according to the contractual terms of the loan agreement(s). Basel Committee, *Sound Practices for Loan Accounting and Disclosure* (July 1999). In this volume, this author will mainly use the term "non-performing loans (NPLs)"; while other terms such as "impaired loans", will only be used occasionally.

² Then NPLs concentrated on loans to the agricultural sector, totaled RMB4.5bn in 1962, while NPLs to industrial sector were only RMB6bn. Altogether NPLs were RMB10.5bn, accounting to 15.3% of the outstanding loans in 1962. All these NPLs were written off in 1962. See Qing, Chi-jiang, 'Bank NPL Problem in China' in Policy Study Office of PBOC, *Issues on Bank and Enterprise Debt Restructuring*, 20, at 20 (Beijing 1995). Qing then headed the Finance Research Institute of the PBOC.

³ In addition to the 1962 write-off, there was another overall write-off in 1979, with NPLs amounting to RMB5.5bn. *Id.*

⁴ See generally 'Decisions on Issues Concerning the Establishment of the Socialist Market Economy System', *Beijing: Xinhua Monthly* 6 (November 1993).

⁵ See Resolution on Financial System Reform, State Council, No. 91 (1993).

The real initiatives to solve the problem, however, did not begin to be implemented until the burst of the Asian financial crisis in 1997. The severity of the Asian financial crisis⁶ taught the Chinese government the importance of having a healthy financial system. There have been internal pressures to solve the problem as well. The collapse of several financial institutions in the latter part of the 1990s⁷ raised concerns about the health of the financial system. Moreover, the economic deflation⁸ induced the government to recognize that NPLs started hurting the real economy.⁹ This adverse situation depleted corporate profits and undermined the ability of weaker companies, mainly in the State-owned sector, to service their debts with banks — thus, undermining further the financial position of China's major banks.¹⁰

⁶ The Asian financial crisis involved several mutually reinforcing events, starting with the devaluation of the Thai baht in July 1997, and followed by devaluations of other currencies, the attack on the Hong Kong dollar in October 1997, a rapid withdrawal of foreign private capital, bank runs, sovereign downgrades, and a dramatic decline in real economic activity. The crisis was felt particularly severe in Indonesia, Korea, and Thailand. There was a \$17.2bn rescue for Thailand, and a \$42bn package for Indonesia. South Korea got a whopping \$58.4bn when it was on the verge of bankruptcy. Other countries in the region also experienced some of the effects of the financial turmoil, such as Malaysia and the Philippines, although they did not suffer a full-blown crisis. See, e.g., Philips, Michael M., 'One by One: A Look at How the Global Finance Crisis Began', *Asian Wall St. J.*, S2 (May 3, 1999). In this volume, these five countries (Thailand, Indonesia, South Korea, Malaysia and Philippines) will be referred to as "Asian crisis countries."

⁷ That is, the closures of China Rural Trust and Investment Corp. in January 1997, Hainan Development Bank on 21 May 1998, China New Technology Venture Capital Corp. on June 22, 1998; and Pudong United Trust and Investment Corporation, a Shanghai-based finance company in the third quarter of 1998; and the most notorious, Guangdong International Trust and Investment Corporation in 1999.

⁸ Notwithstanding the fact that China has so far kept itself relatively immune from the "contagion" bred by the Asian financial crisis and has managed to maintain good economic growth: China managed an 7.8% annual GDP growth in 1998 and 7.1% in 1999 [See, e.g., Harding James, 'China: High Growth Rate "Lacks Quality"', *Fin. Times* (January 4, 1999)], the deteriorating macro-economic situation in China is obvious. According to Wu Jinglian, a prominent Chinese economist, China began to experience deflation from mid-1997 [See Wu Jinglian, 'The Macroeconomic Trend in 1999 and Policy Options' in *Strengthening the Banking System in China: Issues and Experience*, BIS Policy Papers No. 7, 116, at 116-7 (October 1999)].

⁹ The PBOC announced on October 19, 1999 that it was using monetary policy initiatives to combat deflation. The new deflation-fighting monetary policy initiatives include: reducing the reserve requirement ratio for Chinese banks, allowing commercial banks more freedom in deciding interest rates, effecting open-market purchases of bonds by the central bank, permitting securities firms to raise funds by issuing corporate bond, increasing PBOC lending to small and medium-sized financial institutions, encouraging commercial banks to lend to small and medium-sized enterprises, expanding loans to individuals for housing, car and education, and giving preference in lending to high-tech and science & technology development companies. See Chinaonline, 'China Unveils New Weapons in War on Deflation' (October 20, 1999), available at '<http://www.chinaonline.com/topstories/C9101904.asp>'.

The efficiency of these monetary policy initiatives relies heavily on the efficiency of the banking system. In other words, without an efficient financial system, the deterioration in the macro-economy cannot be reversed efficiently.

¹⁰ Standard & Poor, when downgrading five Chinese financial institutions on March 1, 1999, reasoned that the rating revisions reflected Standard & Poor's expectation that the domestic operating environment for Chinese financial institutions would become increasingly difficult as a result of the slowed economic growth and corporate restructuring. Despite repeated interest rate reductions and infrastructure spending by the Chinese government, domestic demand remains weak and deflationary pressures are mounting. The strain will accentuate the existing problems of excess inventory and industrial capacity and declining profits facing state-owned enterprises, which are the major borrowers at the Chinese financial institutions. This negative trend,

On November 17-19, 1997, the Central Committee of the CPC and the State Council held the National Financial Working Conference in Beijing.¹¹ The conference was held against the backdrop of financial crises in three Asian countries — Thailand, Indonesia, and Korea — that had sought massive international financial assistance coordinated by the International Monetary Fund (IMF).¹² The meeting focused on similarities between the financial sector in China and those elsewhere in Asia¹³ and called to establish a financial system compatible with a “socialist market” economy and to strengthen the risk management capacity of Chinese financial institutions in about three years.¹⁴

In the wake of the November 1997 financial conference, the government announced important steps to reduce the risks that the Asian financial “contagion” would spread to China, including but not limited to: (1) the reorganization of the local branches of the PBOC along regional lines in order to reduce political interference in lending decisions at the local level, with the purpose of ending the common practice of provincial governors and party officials influencing the flow of lending in their regions (see Annex XI); (2) the injection of

which will likely continue over the coming year 2001, has already begun to squeeze profits and boost non-performing assets. See Standard & Poor's CreditWire, 'Ratings Lowered on Five Chinese Financial Institutions; Removed from CreditWatch Negative', available at '<http://www.ratings.standardpoor.com/news/newsrelease.htm>'.

¹¹ The Conference was an unusually high-level national financial working conference, addressed by President Jiang Zemin, Premier Li Peng and Vice Premier Zhu Rongji. Other participants in the Beijing meeting included not only central bank officials at the national and provincial level, officials from the headquarters and major provincial branches of China's state-owned banks, insurance companies, and many non-bank financial institutions, but also provincial governors and provincial-level finance officials. See Lardy, Nicholas R., *China's Unfinished Economic Revolution*, 202-3 (1998).

¹² Indeed, in an unprecedented move, China contributed US\$1bn to the IMF-led bailout of Thailand in 1997.

¹³ In terms of fundamentals, a clear lesson of the Asian crisis is that it is dangerous for a country to have weak, poorly regulated banks, making policy loans to inefficient, over-leveraged state enterprises — a reasonable description of China [See Fernald, John G. & Babson, Oliver D., 'Why China Survived the Asian Crisis So Well? What Risks Remain?', 1, *Board of Fed. Internal Finance Discussion Papers* No. 633 (February 1999)]. Four fundamental similarities can be identified between China and the crisis countries: First, the rate of increase in bank credit since reform began in China is similar to that experienced in other countries before the emergence of major banking crisis. In Thailand, for example, there was a five-year period in which bank lending expanded at an annual rate of 25%, three times the rate of real economic growth [See Sapsford, Jathon, 'The Outlook: What Asia May Need Is Far Slower Growth', *Wall Street Journal*, A1 (November 3, 1997)]. The run-up in credit by financial institutions in China, more than 21% a year since 1978, has been almost as fast. Moreover, this expansion has been sustained for decades [See Dai Xianglong, 'Improve Financial Services to Assist Reform and Progress of SOEs in Accordance with the Guideline of 4th Plenary of the 15th Central Committee of CPC', *China Finance*, No. 11, 4, at 5 (November 1999)]. In both countries, the expansion of banking credit was encouraged by the government [*supra* note 11(Lardy), at 203 (1998)]. Second, a common feature shared by China's financial system and that of Asian crisis countries was that their financial systems are heavily bank dominated. Third, central banks are weak in China and Asian crisis countries. Their weakness seriously obstructs them from exercising adequate prudential supervision over commercial lending. The fourth similarity is the pervasiveness of NPL problem with Chinese banks and banks in the Asian crisis countries.

¹⁴ See Historical Research Unit of the Central Committee of the CPC, 'Major Events after the Third Session of the Eleventh Central Committee of the Communist Party of China (III) (*zhonggong shiyijie sanzongquanhui yilei dashiji-xia*)', *People's Daily (Overseas Edition)*, 3 (December 16, 1999).

RMB270bn in new capital to the “big four”¹⁵ in 1998; (3) the write-off of enterprise bad debts;¹⁶ (4) policies encouraging banks to take risks into account when they set interest rates for specific borrowers;¹⁷ (5) the introduction of asset-to-liability ratio management and the removal of the credit ceiling on banks; (6) the introduction of a new loan classification and provisioning system more closely aligned with international standards (see Annex XII);¹⁸ (7) the enhancement of controls on international borrowings;¹⁹ (8) the establishment of four Asset Management Companies (AMCs) in 1999 to take over and manage NPLs of the four largest State commercial banks;²⁰ and (9) a debt-equity swap scheme to help SOEs back in “the black.” All these policy initiatives will be discussed in this volume, to the extent of their relevance to NPL workout and prevention.

II. STRUCTURE OF THE VOLUME

In addition to this introductory chapter, this volume comprises five chapters. Chapter One analyzes the seriousness and causes of the State bank NPL problem in China. On the basis of these analyses, a comprehensive banking restructuring strategy is recommended as a possible solution. Chapter Two is devoted to NPL workouts in China. The prevention mechanisms, namely prudential banking regulation, bank internal controls and a banking safety net, are discussed in Chapters Three and Four. Concluding observations are drawn in Chapter Five.

In Chapter One, the author applies the theory of “soft budget constraints and market discipline”²¹ and concludes that the ultimate cause of the State commercial bank NPL

¹⁵ The “big four”, for the purpose of this volume, denotes the four largest State commercial banks, *i.e.*, the Industrial and Commercial Bank of China (ICBC), China Construction Bank (CCB), the Agricultural Bank of China (ABC) and the Bank of China (BOC). For a brief review of the history of the big four before 1995, see Lees, Francis A. & Liaw, K. Thomas, *Foreign Participation in China's Banking and Securities Market*, 24-5 (1996).

¹⁶ This program began in 1996 with an allocation of RMB20bn to write-off bad bank debts of enterprises that were being restructured. In 1997 the funds earmarked for this purpose were RMB30bn. In 1998 the amount was increased to RMB 40bn with further increases to follow in 1999 and 2000. See Wang Lihong, ‘Bad Loans Only 5% of Bank Credits’, *China Daily*, 3 (January 17, 1998).

¹⁷ See Sun, Shangwu, ‘Financial Reform Outlined’, *China Daily*, 1 (February 23, 1998). The banks, however, are only allowed to adjust the interest rates within the ceilings and floors set by the PBOC.

¹⁸ See, *e.g.*, *China Daily*, ‘China: Substantial Act Needed to Boost Banking Reform’ (November 8, 1999).

¹⁹ Several new regulations were issued to authorize the State Administration of Exchange Control with the responsibility of ensuring that all international commercial borrowing by domestic institutions is approved in advance and that borrowed amounts do not exceed certain multiples of borrowers’ net assets and foreign exchange earnings.

²⁰ See, *e.g.*, Foo Choy Peng, ‘Beijing Tackles Bad Loans-Asset Firms to Ease State Banks’ Burden with Eye on WTO Entry’, *South China Morning Post* 1 (April 27, 1999).

²¹ For a brief description of the theory of soft budget constraints and market discipline, see Section III, Chapter One.

problem is the failure of market disciplines, due to the State bank-dominated/bank-centric finance, “soft” credits to SOEs by State banks (mainly in the form of policy loans), unnecessary administrative restrictions on banks (credit plan, interest rate control, *etc.*), inappropriate banking regulation and supervision, and weak bank internal controls. The huge amount of NPLs not only have negative effects on the “big four” and the whole banking (financial) system, but also bear negative effects on the country’s economic reform and its real economic growth. It is therefore necessary to tackle the problem immediately. China cannot afford to close and to liquidate its State commercial banks because of these banks’ importance in China’s financial and economic system.

“Regulatory forbearance”,²² despite its advantages of cost-saving, is not suitable for China. The two pre-conditions for the success of regulatory forbearance policy — temporary economic difficulty and fundamental soundness of the banking system — do not exist in China.

A comprehensive bank restructuring strategy is therefore recommended to solve China’s bank NPL problem. This strategy would contain the following components: bank recapitalization, NPL management, enhancement of banking regulation and supervision, and promotion of banking internal controls (especially risk-management capacity). The core of these steps is that the government will need to tackle simultaneously bank and enterprise restructuring, and to deal decisively with the stock of NPL stock and to prevent creation of new NPLs, with measures to improve incentives and institutional skills.

Chapter Two is devoted to NPL workouts. The author argues for government capital injection to enhance the capital of the “big four” on the basis of their state ownership, low profitability and difficulties in raising capital. It is suggested that the Ministry of Finance (MOF), rather than the People’s Bank of China (PBOC), China’s central bank, bear the cost of recapitalization. China’s fiscal situation decides that the government cannot afford to recapitalize the “big four” with current government avenues. The failure of the 1998 RMB270bn recapitalization of the “big four” evidences the failure of *ex ante* recapitalization (*i.e.*, with appropriate burden sharing, the government recapitalizes banks based upon an assessment of probable losses, and banks are left to deal with the major part of the NPLs themselves). China, at present, has chosen to recapitalize the “big four” in a manner between the *ex ante* recapitalization and *ex post* recapitalization (*i.e.*, banks receive public funds as and when they provide financial relief to corporations). As mentioned above, in 1999, four

²² A brief description of regulatory forbearance can be found in Section V, Chapter One.

AMCs were set up to take over NPLs from banks and to carry out corporate debt restructuring. In the meantime, banks are actually being recapitalized by the consideration paid by the AMCs for the NPL.

The AMC approach is perceived as the optimal choice to deal with bank NPLs for countries facing systemic NPL problem.²³ Compared to the approach of leaving NPLs with the banks, the AMC approach bears both macro-economic and micro-economic advantages. China has chosen to have bank-specific AMCs rather than a “centric-AMC”.²⁴ The separate AMCs established in 1999 were the Cinda AMC for the China Construction Bank (CCB), the Dongfang (Orient) AMC for the Bank of China (BOC), China Great Wall AMC for the Agricultural Bank of China (ABC), and China Huarong AMC for the Industrial and Commercial Bank of China (ICBC). This bank-specific approach is based on the primary role of state-owned AMCs in guaranteeing that NPLs in each of the big four would be tackled without delay and allows AMCs to make good use of the bank’s information about the debtors.

Theoretically, there are two basic strategies for managing NPLs, *i.e.*, NPL disposal and debt restructuring. The author argues that AMCs in China mainly should apply the debt-restructuring strategy to deal with the NPLs collected from banks, given the quantity, quality and type of assets collected by AMCs in China, and the market demand for such assets, and because most of the debtors are SOEs at the edge of bankruptcy. If AMCs apply debt collection widely, a massive bankruptcy of SOEs might be triggered and hence de-stabilize the society and the economy. AMCs in China have to dispose of some NPLs, however, because not all NPLs can be restructured.

A sweeping debt-equity swap scheme has been carried out in China, proposing to resolve the bank and enterprise problem simultaneously. The success of the scheme, however, would depend on whether criteria set by the SETC on what enterprises are qualified for the scheme can be fully carried out, whether substantial enterprise reorganization plan will be implemented so that the profitability of enterprises can be really improved, and whether AMCs are able to dispose of the equities they have acquired from the swaps in a timely manner.

²³ The IMF, for example, when organized a bailout package for Indonesia, ruled that the banks’ NPLs had to be handed over to the IBRA. *See, e.g.*, Xinhua English Newswire, ‘11.5 Bln Dollars in Indonesia Bad Bank Assets Seized’ (April 3, 1999), *available at* ‘1999 WL 7931247’.

²⁴ In some countries, such as South Korean, only one public AMC is established to take over NPL from banks. This is named as the centric-AMC model.

The success of the AMC practices in China relies on legal reform, however. At present, China lacks the appropriate legal infrastructure for effective NPL disposal and debt restructuring, resulting in creditor passivity of the banks. It is therefore necessary to reform China's bankruptcy regime and banking regulation so that banks will be more positive in collecting their loans. Moreover, an out-of-court consensual mechanism should be established to facilitate debt restructuring, featuring a neutral party to co-ordinate the negotiation between creditors and debtors, the limitation on the ability of small creditors to block agreements, the seniority of the interim new financing over existing debt and a "standstill" on creditors.

Chapter Three reviews the development of banking regulation and bank internal controls in China. Prudential banking regulation and supervision has developed in line with the Basle Committee Core Principle for Effective Banking Supervision.²⁵ There is room for improvement, however. For example, banks are still required to set their deposit and lending rates within the scope set by the PBOC.

With regard to banking supervision in China, the licensing and structure change approval procedures are still vague to some extent; on-going supervision need to be improved — clearer rules are needed for on-site examination; external independent auditors should play a more positive role in banking supervision; a more efficient early warning system needs to be established; and the sanction provisions in China should not be only *ex post* punishments: there should be incentives for banks to correct their operations.

Chinese banks started developing their internal controls at the end of the 1980s. Following the adoption of the Commercial Banking Law in 1995, the PBOC issued Guidelines for Enhancing Internal Controls of Financial Institutions in 1997,²⁶ in line with the Basle Committee's Framework for Internal Control Systems in Banking Organization.²⁷ But the real problem appears to be how well the rules set by the PBOC can be implemented by banks in China. Due to the sole State ownership, for example, the organizational structure of State commercial banks in China lacks checking and balancing among different organs and is not in consistent with the rules set by the PBOC. Diversifying the ownership structure of the "big four" might be a solution, but there are difficulties at the moment in achieving this

²⁵ Basle Committee, *Core Principles for Effective Banking Supervision* (September 1997), available at '<http://www.bis.org/publ/bdbs30a.htm>'.

²⁶ Guidelines of the PBOC for Enhancing Internal Controls of Financial Institutions [zhongguo renmin yinhang jiaqiang jinrong jiguo neibu kongzhi de zhidao yuanze], issued by the PBOC on May 16, 1997.

²⁷ Basle Committee, *Framework for Internal Control Systems in Banking Organizations* (September 1998), available at '<http://www.bis.org/publ/bcbs40.htm>'.

objective. Information and communication is another example. Due to the poor disclosure and accounting practices in China, and due to the banks' lack of skills and techniques of assessing information, information and communication is the weakest part of bank internal controls in China. Efforts have been taken by the PBOC recently to help commercial banks obtain information about their borrowers. Banks themselves, however, must develop skills and expertise to analyze information appropriately.

Chapter Four covers issues related to a banking safety net, which comprise central bank's lender-of-last-resort (LOLR), deposit insurance and bank insolvency resolution. It is argued that the PBOC's LOLR role should be defined by legislation, clarifying that the PBOC should only extend credit to those temporarily illiquid but not insolvent financial institutions when there is a threat to the soundness and stability of the financial system, and, the extension of the credit is necessary to avoid a serious disturbance in the economy; and that credit advances should be limited in maturity and extendibility and require satisfactory collateral. Procedures for decision-making should be provided as well, such as the authority of person or persons to make the decision (the PBOC Governor/PBOC Monetary Policy Commission) and the consultative requirements (the PBOC should consult with the MOF before it decides to extend emergency credit).

With regard to deposit insurance, it is recommended that China replace the current government implicit guarantee with explicit deposit insurance. A Deposit Insurance Company should be established in China by legislation, providing deposit insurance to deposits in all deposit-taking institutions in China (including the "big four"). The Company would collect premiums from deposit-taking institutions, would manage the deposit insurance fund, and would pay-off depositors when a deposit-institution is closed. It is suggested that this Company should be affiliated to the PBOC, with the authority to inspect and examine the deposit-taking institutions and to deal with problem institutions. Respecting the coverage of deposit insurance in China, it is recommended that the deposit insurance only protect the individual depositors, with a "floor" and "ceiling" fixed for compensation as to each individual depositor.

Effective and timely resolution of insolvencies would reinforce systemic stability, would promote public confidence in the system, and would restore liquidity to the economy. Basic regulatory options to deal with a failed bank might include closure and liquidation, a rescue package (*e.g.*, "open bank assistance"), merger and takeover (*e.g.*, purchase and assumption), bridge bank (*e.g.*, management take-over in China). To date, all these

mechanisms have been applied in some form in China, although the 1995 Commercial Banking Law only provides for the management take-over and liquidation (including bankruptcy) of commercial banks.

There are fundamental problems with China's current insolvency resolution practices, such as the unfair treatment of creditors, the local governments' intervention in the PBOC's discretion in deciding insolvency resolution mechanisms, and inadequate transparency and disclosure. It is recommended that clearer rules be set out in China's Commercial Banking Law concerning bank insolvency resolution in China.

Chapter Five draws some concluding observations. It is concluded that the ultimate cause of state commercial bank NPL problem is the failure of "market discipline" in China. It is therefore necessary to implement a comprehensive banking restructuring to restore market discipline in China. Market discipline cannot be restored without a solid legal framework, including laws respecting AMC practices in China, legislation on prudential banking regulation, and legislation on a banking "safety net."

III. METHODOLOGIES

A. GENERALIZATION VS. SPECIALIZATION

The methodology of "generalization vs. specialization" is carried out through this whole study.²⁸ In analyzing the causes of China's bank NPL problem, the author identifies the direct causes of bank NPL problem — *i.e.* — the State bank-dominated, bank-centric finance, the policy loans to SOEs, administrative controls on banking activities, inappropriate banking regulation and poor bank internal controls — within the broad background of China's overall economic reforms. Instead of trying to provide some broad policy suggestion, the author recommends a solution directly targeting these problems.

This study, however, is not limited to the "big four" state commercial banks. Other financial institutions, including the three policy banks,²⁹ joint stock commercial banks, city commercial banks, urban and rural credit cooperatives, foreign banks, *etc.*, are also tackled to

²⁸ "To generalize" means to study a issue against its broad background; "to specialize" means to impose limitations to qualify the study.

²⁹ They are: the State Development Bank, the Agricultural Development Bank and the State Import-Export Bank.

the extent of their relevance. Further, this study is not limited to the banking industry: the whole financial industry and even the corporate sector are touched upon in this manuscript.

The methodology is also carried out in terms of international and comparative studies. For example, the author focuses mainly on the experiences and lessons from recent Asian crisis countries, because of similarities between China and these countries, and because of the availability of materials. Experiences in other countries such as the US, the UK, Japan, and the Eastern and Central European countries are studied as well. With regard to banking regulation and supervision, the author mainly refers to the documents issued by the Basle Committee, although regional practices such as the European Community banking policies and national experiences in selected countries are referred to sometimes.

B. ECONOMIC ANALYSIS VS. LEGAL ANALYSIS

The author provides a joint substantial consideration (legal and economic) of issues related to bank NPLs.³⁰ Macro-economic analyses are employed in studying the causes of bank NPLs and their solution. The legal analyses, however, is used to support the main themes of this volume, by grounding proposals on economic analyses articulated by legal analyses and legislative proposals.³¹

³⁰ See, e.g., Lastra, Rosa Maria, *Central Banking and Banking Regulation* (1996). Dr. Lastra names this method “macro-economic analysis of law” and distinguished it from the traditional “economic analysis of law”. *Id.*, at 6-7.

³¹ E.g., the study in this volume focuses on, but not limit to, legislation on the banking regime. In addition to financial legislation, property law, contract law, company law and bankruptcy law are also discussed to the extent of their relevance.

I. INTRODUCTION

A clear diagnosis is one of the basic principles for successful bank restructuring — a clear diagnosis helps “identifying the underlying causes of the banking problem and designing a strategy aiming at addressing each of them, and not just their symptoms in the banks’ balance sheets.”¹ This chapter first examines the seriousness of the bank NPL problem in China, followed by analyses on the causes of the bank NPL. Afterwards, possible strategies towards the bank NPL problem are explored, with a comprehensive bank restructuring strategy recommended as a possible solution.

The rest of the chapter is organized as follows: Section II refers to different estimates of China’s bank NPLs and describes their negative effects on State banks, the entire banking system, the country’s economic reform, and its real economic growth. Sections III, IV analyze the causes to China’s bank NPL problem. A theoretical framework is established in Section III — that soft budget constraints and the deterioration of market discipline are the ultimate cause of the bank NPL problem, followed by empirical analyses in Section IV. In Section V, after comparison between the three main strategies (bank closure and liquidation in large scale, regulatory forbearance, and comprehensive bank restructuring) towards the bank NPL problem, a comprehensive bank restructuring strategy is recommended to solve China’s bank NPL problem. The Chapter finishes with some concluding observations in Section VI.

II. THE SERIOUSNESS OF THE BANK NPL PROBLEM IN CHINA

¹ See Dornbusch, Rudi & Giavazzi, Francesco, ‘Heading off China’s Financial Crisis’ in *Strengthening the Banking System in China: Issues and Experience*, BIS Policy Papers No. 7, 40, at 46 (October 1999). Cf. Andrew, Sheng,

A. THE SERIOUSNESS: LARGE AMOUNT OF EXISTING NPLS AND INCREASING NEW NPLS

The seriousness of the State commercial bank NPL problem can hardly be overweighed. Chinese Scholars' estimates of the proportion of NPLs to bank assets have varied from 10 % to 40 %.² "Two reasons contribute to the variety: one is that different asset classification standards have been applied; the other is that most estimation was based on samples rather than on comprehensive surveys. What can be said without doubt is that the huge amount of NPLs accumulated on [State] banks' balance sheets may have very serious consequences and must be paid attention to."³

There is no official disclosure of the NPL amount. The best data available to outsiders are that of the "big four" released by the PBOC governor Dai Xianglong and other high ranking banking officials. It was stated that NPLs of the "big four", as a share of their total outstanding loans, increased from 20% at year-end 1994 to 22% at year-end 1995, and then to 25% at year-end 1997.⁴ Some foreign observers believe, however, the ratios are much higher. Goldman Sachs, for example, asserted that a more stringent and internationally accepted classification would show that the mainland's banking sector had one of the highest NPL levels in Asia, ranging from 30 to 60 percent of outstanding bank loans.⁵

'The Framework for Financial Supervision: Macro and Micro Issues' in *Strengthening the Banking System in China: Issues and Experience*, BIS Policy Papers No. 7, 154, at 155-6 (October 1999).

² Different estimates of the proportion of NPLs to the total State commercial banks' asset can be found in the following publications — 10%: Pan, Yue (ed.), *Policies and Procedures for Asset Restructuring*, 31 (Beijing: 1997); 20%: Policy Study Office of the PBOC, *Issues on Bank and Enterprise Debt Restructuring* (Beijing 1995); 22.3%: Yi, Gang, 'The Asset Structure of China's Financial Institutions and Its Policy Implication', *Jingji Yanjiu* No. 12 (1996); 20-30%: Huang, Yuncheng, 'Bank Reform and Debt Restructuring', *Beijing: Guanli Shijie* No. 6 (1996); 30%: Xv, Jingyong, 'Causes of the Deterioration of the Asset Quality of State Specialized Banks', *Dangdai Jingji Yanjiu* No. 1 (1996); 25-40%: Lu, Xianxiang, 'Problems with the Three Lending Models of China's Commercial Banks', *Guoji Jingrong Yanjiu* No. 12 (1996).

³ See Qing, Chi-jiang, 'Bank NPL Problem in China' in Policy Study Office of the PBOC, *Issues on Bank and Enterprise Debt Restructuring*, 20, at 21 (Beijing 1995). Qing headed of the Policy Study Office of the PBOC then.

⁴ The total figure for NPLs include those that were overdue for less than one year and might be recovered, there is also a core of bad and doubtful loans that would have to be written off. These amounted to between 7 and 10 per cent of total lending. See, e.g., Montagnon, Peter & Harding, James, 'China: Bank Cut Non-performing Loans', *Fin. Times* (September 13, 1999); Faison, S., 'Inflation Curbed but Not Growth, China Asserts', *New York Times* (July 16, 1996); and Lardy, Nicholas R., 'The Challenge of Bank Restructuring in China' in *Strengthening the Banking System in China: Issues and Experience*, BIS Policy Papers No.7, 26 (October 1999).

⁵ The outstanding loans amounted to RMB9.6 trillion at March 31, 1999, 110% of the GDP that year. See Wang, Xiangwei, 'Goldman Puts Loan Clean-up Bill at US\$272bn', *South China Morning Post*, 4 (September 24, 1999).

Making matters worse, despite large write-offs in recent years,⁶ NPL levels have been rising steadily in China.⁷ An article based on an interview with Dai Xianglong, then vice-governor of the PBOC, states that the proportion of NPLs to total outstanding loans of China's State-owned banks "has been rising by 2 percentage points per annum in recent years."⁸ The PBOC Governor admitted in his speech at the annual Session of the NPC on March 11, 1999 that, "owing to the unsatisfactory performance of state-owned enterprises, the trend of increasing non-performing loans has yet to be checked".⁹

B. NEGATIVE EFFECTS OF STATE BANK NPLS

1. Negative Effects on State Banks

The NPL problem has been a major obstacle preventing the "big four" from becoming genuine commercial banks. Huge amounts of bad assets are damaging their profitability and competitive ability, and impeding them from improving their economic efficiency. If the creation of NPLs cannot be curbed effectively, the NPL problem will eventually lead to the collapse of the "big four" and eventually the entire banking system.

(i) *The decreasing profitability of the "big four"*

NPLs have direct decreasing effects on bank profits: Banks have to write off and provision for NPLs. This decreases their profits substantially.¹⁰ As shown in Table 1.1, the average profit

⁶ It is reported that China wrote off RMB 30bn (US \$ 3.62bn) in bad debts in 1997 and RMB40bn (US \$ 4.83bn) in 1998. See, e.g., Chinaonline, 'China Wrote Off US \$ 3.62 Billion in Bad Debts in 1997, US \$ 4.83 Billion in 1998', available at 'http://www.chinaonline.com/top_stories/breakingnews_c9022405.html'. These two years writing off was on the basis of a RMB 23.8bn writing off in 1996. See the PBOC, *China Financial Outlook 1998*, 20 (Beijing: 1998).

⁷ China's banking sector has been increasing loans to inefficient SOEs at a rate that outstrips the output growth, thereby heaping new NPLs on old-ones. See, e.g., Harding, James, 'China: Market Differences Emphasized', *Fin. Times* (January 28, 1999).

⁸ See Zhao Yining, 'The Financial Situation and Financial Reform', *Liangwang (Outlook)*, 12-3 (May 15, 1995).

⁹ See Harding, James, 'China: Banks to Be Allowed to Price Risks', *Fin. Times* (March 12, 1999).

¹⁰ The CCB, for example, generated book profits of RMB 2.2bn (US \$ 266 m) in 1998. The actual profits, however, were only RMB 850 m (US \$ 102.7 m), 44% down from the RMB 1.51bn in 1997. Zhou Xiaochuan, then the CCB governor, said the bank experienced an increase in expenditures and a decrease in profits. In addition to the government's cut in interest rates, adjustments made to the bank's interest receivables, and the summer floods, he attributed decreased profits to the increase in provisions for the NPLs. Provisions for NPLs rose by RMB 7.9bn (US \$ 954 m) year on year. See, e.g., 'China's Top Five Commercial Banks Report 1998 Account Balances', available

margin of the “big four” from 1995 to 1997 was only 0.26% and showed a decreasing tendency, while the profitability of the ten new commercial banks¹¹ during the same period was 1.70% and showed an increasing tendency. One of the reasons that these newly emerged banks over-performed the “big four” is that they had a very low NPL level.¹²

Table 1.1: Profits Margin of Banks in China (percentage): 1995-1997

	1995	1996	1997	Period Average
The big four	0.35	0.32	0.12	0.26
Ten New Commercial Banks	1.68	1.60	1.82	1.70
City Commercial Banks	n.a.	2.00	0.91	1.46
Foreign Banks in China	0.73	0.61	0.67	0.67

Source: Table 5 in Yu, Liangchun & Jv, Yuan, ‘Monopoly and Competition: Banking Monopoly and Competition in China [rongduan yu jingzheng: zhongguo yinghang ye de gaige yu fanzhan], *Economic Research Journal* No. 8, 48, at 53(1999).

(ii) *The Deteriorating Creditworthiness of State Commercial Banks*

The accumulation of NPLs has seriously degraded State banks’ credit standing, as evidenced by the downgrading of five Chinese financial institutions by Standards and Poor on March 1, 1999.¹³

at ‘http://www.chinaonline.com/top_stories/today_b9012040.html’; and Harding, James, ‘China: Profits Under Pressure’, *Fin. Times* (January 22, 1999).

¹¹ They are: BOCOM, CITIC Industrial Bank, China Everbright Bank, Huaxia Bank, China Minsheng Banking, Guangdong Development Bank, Shenzhen Development Bank, Merchant Bank, Fujian Industrial Bank and Shanghai Pudong Development Bank.

¹² It is estimated that NPLs only account for 2.36% of the outstanding loans of the emerging commercial banks. See, e.g., Yu, Liangchun & Jv, Yuan, ‘Monopoly and Competition: Banking Monopoly and Competition in China [rongduan yu jingzheng: zhongguo yinghang ye de gaige yu fanzhan], *Economic Research Journal* No. 8, 48, at 55 (1999).

¹³ See, e.g., Harding, James, ‘China: Financial Institution Downgraded’, *Fin. Times* (March 2, 1999). Standard & Poor lowered the foreign currency counterpart credit, certificate of deposit, and debt ratings on five Chinese financial institutions: the ICBC, the CCB, the BOC, the Bank of Communications (BOCOM), and China International Trust & Investment Corp. (CITIC).

According to Standard & Poor Credit-Wire,¹⁴ in addition to the adverse macro-economic environment, poor asset quality and increased write-offs have limited each institution's ability to improve its credit standing.

Moody's rated China's average bank financial strength at "D", *i.e.*, very weak, in July 1999. That was worse than all other countries being rated except Korea, Pakistan, Thailand, Indonesia and Russia.¹⁵

(iii) *The Potential Failure of State Commercial Banks and the Entire Banking System*

The accumulation of NPLs has historically been one of the direct causes of bank failures. In the US, loan losses dominated the major bank failures from 1934 to 1983.¹⁶

The huge amount of NPLs has already made the "big four" technically insolvent.¹⁷ They are running mainly on government support and the public's confidence in them.¹⁸ Or, in Nicholas Lardy's words, "the 'big four' are insolvent, but not illiquid".¹⁹

Given the weightiness of the "big four" in the entire banking system,²⁰ it would not be exaggerating to assert that if the creation of new NPLs cannot be effectively curbed, the

¹⁴ See Standard & Poor's CreditWire, 'Ratings Lowered on Five Chinese Financial Institutions; Removed from CreditWatch Negative', available at '<http://www.ratings.standardpoor.com/news/newsrelease.htm>'.

¹⁵ See Moody's Investors Service, 'Average Bank Financial Strength Rating by Country' in *Banking System Outlook: Singapore*, 5.

¹⁶ See Table 9.2 of Nagle, Reid & Petersen, Bruce, 'Capitalization Problems in Perspective', in Aspinwall, Richard C. & Eisenbeis Robert A (eds.), *Handbook for Banking Strategy* (1985).

¹⁷ As of 1995, for example, it was revealed that then overdue loans, dead loans and irrecoverable loans constituted 12%, 8% and 2% respectively of the combined value of the loan portfolios of the "big four". See, *e.g.*, Tang Xiong, 'How to Calculate the Bank's Non-Performing Assets', *Jinrong Shibao (Financial Times)*, 5 (April 21, 1996).

Since the loans outstanding of these four institutions at year-end 1995 stood at RMB3.9bn, classified loans can be estimated at RMB860bn. Of these RMB469bn were overdue, RMB313 were dead loans, and RMB78bn were irrecoverable. The total net worth of these banks at year-end 1995, including paid-in capital, surpluses, and retained profits, stood at only RMB269bn. Deducting the value of irrecoverable loans, the net worth of these institutions would be only RMB191bn. If the ultimate recovery rate on the remaining classified loans were less than 3/4, the magnitude of loans to be written off would exceed the remaining net worth of these banks. See Lardy, Nicholas R., *China's Unfinished Economic Revolution*, 119 (1998).

See also Li Xinxin, 'Looking at China's Hidden Financial Danger from the Perspective of the East Asian Financial Crisis: An Analysis of the Utilization and Management of Assets by China's State-Owned Commercial Banks', *Gaige (Beijing)* No. 3, 32 (1998). Li Xinxin is one of the few Chinese authors who have explicitly acknowledged that the liabilities of the "big four" exceeded their assets.

¹⁸ A survey conducted by the Task Team of the Huaihua PBOC Branch in 1998 shows the public confidence in State owned commercial banks. See The Task Team of the Huaihua PBOC Branch, 'Depositors' Consciousness of Financial Risks and the Bank Exit System [chunquanren de fengxian yishi yu yinghangye de tuichu zhidu], *Jinrong Jingji (Changsha)* No. 9, 3-6 (1998).

¹⁹ See Lardy, Nicholas R., *supra* note 4, at 31.

²⁰ See *infra* note 83 and the accompanying text.

accumulating NPLs will eventually pull down the “big four” and even the entire banking system in China.²¹

2. Negative Effects on the country's Economic Reform and Its Real Economy Growth

(i) *Negative Effects on the Economic Reform towards a Market Economy*

The building of a market economy requires the creation of markets, market-oriented enterprises, and a wide range of institutions and business practices to support them. For markets to function well there must be a robust entry in and disciplined exit from markets to ensure that the most efficient and innovative producers are those that operate in the markets.²²

The presence of NPLs on banks' balance sheets distorts the incentives for both banks and SOEs. It has been proven that large amounts of NPLs frequently lead to the adverse selection of bank and firm managers.²³ Lenders are forced to consider a workout loan when borrowers lose access to financial markets and must seek new loans from existing creditors to continue servicing outstanding debt.²⁴ The distortion of the lending decision is most extreme if the bank is so heavily exposed to a borrower that the bank would fail if the workout loan were not made. In this case, the bank will be willing to make the loan so long as there is some chance — however negligible — the workout loan will succeed.²⁵ Firms' managers, on the other hand, are under no pressure to scrutinize their projects, because they know that banks have no alternatives but to keep lending. In China, the adverse selection is not limited to banks and SOEs. Most adverse selections are under the explicit or implicit instruction of the government.²⁶

The banks' passivity in enforcing loan contracts and willingness to grant new loans to loss-making SOEs has fostered the reliance of SOEs on State banks and reduced their willingness

²¹ See, e.g., Jiang, Chun, 'On the Essence of Finance and Institutional Prerequisites [lun jinrong de shizhi ji zhidu qianti]', *Economic Research Journal* No. 7, 33, at 35 (July 1999).

²² See, e.g., European Bank for Reconstruction and Development, *Transition Report 1998: Financial Sector in Transition*, iv (1998).

²³ See e.g., Herring, Richard, J. 'The Economics of Workout Lending', 21 *Journal of Money, Credit, and Banking* No. 1, 1 at 5 (Feb. 1989).

²⁴ *Id.*, at 1.

²⁵ In other words, additional lending to allow bankrupt firms to service the old loans becomes rational, as it enables banks to report the loans as formally performing, thus delayed the day of reckoning.

²⁶ See Yuan, Gangming, 'Empirical Analyses on China SOEs' Bad Debts [zhongguo guoyu qiye buliang fuzhai de shizheng fengxi]', *Economic Research Journal* No. 12, 12, at 15 (2000).

and ability to adjust their production to changing demands and respond to market signals.²⁷ More seriously, adjusting to “soft” loans from state banks, some enterprises cling to the idea that they do not have a legal obligation to repay loans,²⁸ while an acute sense of trust in day-to-day dealings is essential to a market-oriented economy.

(ii) *Negative Effects on the Real Economy*

It is now well accepted²⁹ that the performance of the financial sector has a major influence on the performance of the overall economy, by mobilizing domestic and foreign savings and efficiently allocating these funds to investment opportunities in the real economy. A sound financial sector is also a source of stability, providing a mechanism for allocating risks and spreading financial losses that inevitably arise from economic activities. The financial crises in emerging markets demonstrate fully how weak banking systems could damage the economy as a whole.³⁰ As banks are the key providers of funds to the industry and commerce in China, their fragility certainly has a negative impact on the real economy.

Failures in the financial sector hurt other business and eventually the whole economy.³¹ This has been fully shown in the failure of the Guangdong International Trust and Investment

²⁷ It is reported that 66.7% per cent of 605 key manufactured products in China were in oversupply. That is to some extent due to the weak market responsiveness of SOEs. See, e.g., Kynge, James, ‘China: Products in ‘Oversupply’’, *Fin. Times* (February 5, 1999).

²⁸ In 1999, the PBOC and the State Economic and Trade Commission (SETC) issued jointly the Report on Collecting Bank Interest Arrears According to Law, which revealed that among all the interest arrears, 20% were owed by the debtors who had the capacity to repay the interests. See Circular of the General Office of the State Council on Issuing the Report of the PBOC and the SETC on Collecting Bank Interest Arrears According to Law, issued on January 21, 1999.

²⁹ There is a large literature demonstrating a significant correlation between the financial development and economic growth. See, e.g., King, Robert G. & Levine, Ross, ‘Finance and Growth: Schumpeter Might Be Right’, 53 *Quarterly Journal of Economics* 715-37 (August 1993); Pagano, Marco, ‘Financial Market and Growth: An Overview’, 37 *European Economic Review* 613-22 (April 1993); and also Stiglitz, Joseph E., ‘Financial Market and Development’, 5 *Oxford Review of Economic Policy* 61 (Winter 1989).

The positive correlation between financial development and economic growth exists in China as well. See Tan, Ruyong, ‘An Empirical Study of the Relationship between China’s Financial Development and Economic Growth [zhongguo jinrong fanzhang he jingji zhengzhang guanxi de shizheng yanjiu]’, *Economic Research journal [jingji yanjiu]*, No. 10, 53 (October 1999).

³⁰ See Dornbusch, Rudi & Giavazzi, Francesco, *supra* note 1, at 40.

³¹ For an economic analysis, see, e.g., Kiyotaki, Nobuhiro & Moore, John, ‘Credit Cycles’, 105 *Journal of Political Economy* No. 2, 211 (1997).

Corporation (GITIC), which led to the liquidity crisis spreading across China's financial sector — caused by the retreat of international lenders.³²

Even without obvious failure, large amounts of NPLs have negative impacts on the real economy.³³ The banking sector stress contributed to the 1998 economic slowdown in China. It is pointed out that the huge amount of NPLs, combined with the Asian financial crisis, caused tensions in the Chinese government and the banking sector — banks became cautious about increasing lending, and many projects with uncertain returns were rejected.³⁴ There were companies complaining that many banks avoided giving out loans because of rising NPL levels.³⁵

C. SUMMARY

Although there are disagreements on the exact amount of NPLs accumulated on the State banks' balance sheets, it is widely accepted that NPLs have accumulated to such an extent that they are large enough to threaten the safety and soundness of China's State banks and consequently the entire banking system. Banks are now running on the government support and the public's confidence.

The existence of a sky-high amount of NPLs not only impairs the health of the banking system. More importantly, it impedes banks from granting new loans to the real economy, and impedes the establishment of a market economy in China. Efforts must be made to work out bank NPLs, and to prevent the increasing creation of NPLs on banks' balance sheets.

III. CAUSES OF BANK NPLS — THE THEORETICAL FRAMEWORK

³² See, e.g., Harding, James, 'China: Foreign Banks Get Tough', *Fin. Time* (February 8, 1999); 'China: Foreign Banks Look to Reduced Role', *Fin. Times* (January 27, 1999); 'China: GITIC Failure Starts to Hurt other Businesses', *Fin. Times* (January 22, 1999); and Lucas, Louise & Harding, James, 'China: Confidence Sinks with Full GITIC Debt', *Fin. Times* (January 11, 1999).

³³ The massive overhang of bad debt stifles new, higher-quality lending by banks and acted as a drag on new economic growth. Banks have to make provisions for these loans. High provisioning needs are pushing banks to put available cash aside for potential losses instead of making the new loans needed for the economy. This consequence has already been seen in countries such as Japan and Thailand. See, e.g., Business Week, 'Why Japan is Stuck', available at '1999 WL 8226852'; and Bardacke, Ted, 'Thailand: Debt Makes up 44% of Lending', *Fin. Times* (March 3, 1999).

³⁴ See generally Wu, Renhong, *China's Economic Outlook*, Chinaonline (1999).

³⁵ These complaints were dismissed by the PBOC. According to a PBOC survey, large- and mid-sized companies with healthy profits were still getting needed loans, although credit controls were more stringent and companies were being forced to look for needed capital through other channels. The survey found out that enterprises had been turned down largely because of their poor credit record. See Xinhua English Newswire, 'China's Bank Loans on Target' (April 5, 1999), available at '1999 WL 7931582'.

Before we start to investigate the causes of bank NPLs in China, it is important to recognize that, unlike in Eastern and Central European countries,³⁶ most NPLs of Chinese banks are not inherited from the pre-reform era. Instead, they are mainly created after reform began.³⁷ Dai Xianglong stated that the NPL problem in China resulted from the “transformation of the country’s economic system”.³⁸

China’s economic reform is in transition from a planned economy to a market economy.³⁹ The main idea is for market mechanisms to become the main integrators of the economy — this embraces far-reaching decentralization, a high degree of autonomy to the firm, and the liberalization of prices, with the predominance of State-ownership and a pervasive role of State control.⁴⁰ In this sense, China’s reform is no different than the socialist market reform defined by Janos Kornai⁴¹ and bears the exact problems he pointed out — the bureaucratic coordination of the command economy is lifted without true market discipline being applied.⁴² In the rest of this section, the author will argue that it is the failure of market discipline that has resulted in the huge amounts of NPLs on the balance sheets of Chinese State banks.

A. SOFT BUDGET CONSTRAINTS

1. The Concept of Soft Budget Constraints and Its Application

³⁶ In Hungarian, for example, during the period from 1987 to 1991, more than 51% of the bad debts outstanding were concentrated on big banks. They inherited the bad debts of the big companies granted by the National Bank of Hungary in the one-tier banking system. See, e.g., Ligeti, Sandor, *Problem Loans*, 7, IEF Research Papers in Banking and Finance 93/13 (1993).

³⁷ See Lardy, Nicholas R., *supra* note 17, at 220.

³⁸ See, e.g., Xinhua English Newswire, ‘China Will Not Suffer A Financial Crisis: Official’, (April 3, 1999), available at ‘1999 WL 7931322’.

³⁹ See *China 2020: Development Challenges in the New Century*, the World Bank China 2020 Series (September 1997), Box 2.1. For a detailed discussion about the evolution of the aims for China’s economic reform, see Li, Tianying, ‘The Foundation of Socialist Market Economic Theory and A Significant Breakthrough — in Commemoration of the 20th Anniversary of the 3rd Plenary Session of the 11th Central Committee of CPC [shehui zhuyi shichang jingji lilun de xingcheng he zhongda tupo- jinian zhongguo gongchandang di shiyijie sanzong quanhui ershi zhounian]’, *Economic Research Journal* No. 3, 3 (March 1999).

⁴⁰ See ‘Accelerate the Reform and Openness, Promote the Modernization Drive, Striving for New Victories in the Way of the Socialism with Chinese Characteristics’ - Jiang Zemin’s address at the 14th National Congress of the CPC, *People’s Daily*, 2 (October 13, 1992).

⁴¹ Janos Kornai characterizes the reform socialism with (1) the ruling role of the Communist party with somewhat mitigating the repression and allowing a degree of freedom for alternative views; (2) the pervasive role of state control and the subordination of the economy to the bureaucracy; (3) the predominance of state-ownership; (4) the development of market coordination as the main integrators of the economy; and (5) the development of the private sector confined with some limits. See Kornai, Janos, *Highway and Byways*, 59 (1995).

The concept of soft budget constraint was first introduced by Janos Kornai in 1980.⁴³ Kornai defines the budget constraint as a rational planning postulate with two important properties: first, the budget constraint refers to a behavioral characteristic of the decision-maker (he adjusts his expenditures to his financial resources); second, the budget constraint is a constraint on *ex ante* variables and most of all on demand (it is based on expectations concerning his future financial situation when the actual expenditure will occur). The “softening” of budget constraints appears when the strict relationships between expenditures and earnings are relaxed, *i.e.*, when excess expenditures over earnings will be paid by some other institutions, typically the State. A further condition of “softening” is that the decision-maker expects such external financial assistance with high probability and this probability is firmly built into his behaviors.

Kornai's conceptual framework is most widely used in discussing the economies of Eastern Europe,⁴⁴ although it has been more recently applied to China by Kornai himself⁴⁵ and other western scholars,⁴⁶ as well as Chinese scholars.⁴⁷ These applications, however, mainly test the concept with evidences in China.

2. Consequences of Soft Budget Constraints

The soft budget constraints on firms have many interrelated consequences.⁴⁸ As for its impact on a firm's conducts, three consequences can be identified: weak price responsiveness, low

⁴² *Id.*, at 44-45; and Kornai, Janos, *The Socialist System: The Political Economy of Communism*, 497-498 (1992).

⁴³ See Kornai, Janos, *Economics of Shortage* (1980). For a more detailed explanation of the concept, see Kornai, Janos, 'The Soft Budget Constraint', 39 *Kyklos* 1, 3 (1986).

⁴⁴ See, *e.g.*, Kornai, Janos, 'The Hungarian Reform Process: Visions, Hopes and Reality', 24 *Journal of Economic Literature* No. 4 (1986).

⁴⁵ See, *e.g.*, Kornai, Janos, *Vision and Reality, Market and State*, 35-36, 192-193 (1990); and also 'The Soft Budget Constraint', 39 *Kyklos* 1 (1986).

⁴⁶ See, *e.g.*, Blejer, Mario I. & Gyorgy Szapary, 'The Evolving Role of Tax Policy in China', 14 *Journal of Comparative Economics* No. 3, 452 (September 1990); Bowles, Paul & Gordon White, 'Contradictions in China's Financial Reforms: The relationship between Banks and Enterprises', 13 *Cambridge Journal of Economics* No. 4, 481 (December 1989); and Wong, Christine P. W., 'The Economics of Shortage and Problems of Reform in Chinese Industry', 10 *Journal of Comparative Economics* No. 4 363 (December 1986).

⁴⁷ See, *e.g.*, Jiang, Sidong *et al.*, 'Financial Reform, the Two-track System: Strengthen Credit Restraint, Open up a Capital Market among the People,' *Chinese Economic Structural Reform Research Institute (Beijing): Research Reports* No. 25 (November 29, 1985).

⁴⁸ For a detailed discussion of all those consequences, see generally Kornai, Janos, *Contradictions and Dilemmas* 42-44 (1986).

efficiency, and excess demand.⁴⁹ The softness of budget constraints diminishes the firm's sensitivity towards price fluctuation and, thereafter, invalidates the banks' efforts to curb unsustainable borrowing by charging higher interest rates. Weak price responsiveness can lead to low efficiency of firms: allocation efficiency cannot be achieved when input-output combinations do not adjust to price signals. Under soft budget constraints, there is not a sufficiently strong stimulus for a firm to maximize its profits. More seriously, when the external circumstances are unfavorable, the firm is not forced to adjust to changed situation; instead, it is likely to seek external assistance. A third syndrome of soft budget constraints is the formation of excess demand. Whatever goals the firm managers have (maximizing short- or long-term profits, sales, the size of the firm, and the discretion and power), these objectives, or any combination of them will be associated with expansion — termed by Jonas Kornai as 'investment hunger syndrome'.⁵⁰

3. Sources of Soft Budget Constraints

The soft budget constraints have a number of sources. Kornai points to soft subsidies granted by national or local government, soft taxation (under this firms in difficulties are granted tax concession or allowed to postpone payment of their taxes), soft credits, and soft administrative prices.⁵¹ Among them, soft credits contribute directly to NPLs.

B. MARKET DISCIPLINE — A MECHANISM TO CURB SOFT CREDIT

Market discipline is by no means a new concept to the financial world. Whenever there are doubts about the efficiency and effectiveness of financial regulation, people turn to concepts such as market forces, market place or market discipline in the hope that the market can solve

⁴⁹ The discussion in this paragraph draws heavily from Kornai, Janos, 'The Soft Budget Constraint', 39 *Kyklos* 1, 3 (1986).

⁵⁰ See Kornai, Janos, *supra* note 41, at 189. Over-investment had been a chronic problem during China's classical socialist period. For a detailed discussion, see Chang, Hsin, 'The 1982-83 Over-investment Crisis in China', 24 *Asian Survey* No. 12, 1277 (December 1984). The investment hunger syndrome survived the economic reform started in 1978 with two new characteristics. One is a rise in the proportion of a firm's profits that it needs not hand over to the State budget and can use to finance investment of its own. The other is a reduction within the entirety of the outside resources for investment in subsidies from the State budget that need not be repaid and increase in bank credits that have to be repaid with interests. *Id.*

⁵¹ See Kornai, Janos, *supra* note 42, at 140-42 & 489; *The Economics of Shortage*, *supra* note 43, Ch. 13.

problems better than the government. William McDonough, president of the Federal Reserve Bank of New York and Chairman of the Basle Committee on Banking Supervision, when talking about the reform for the 1988 Basle Accord,⁵² insisted on the need for reliance on market discipline and said that “the new framework was supposed to include as great as possible a reliance on market discipline, with emphasis on transparency and disclosure”.⁵³

1. General Introduction — the Theory of Market Discipline

Timothy Lane developed the theory of market discipline by studying the experience of federal unions, ranging from tight central control of borrowing by lower levels of government to virtually complete reliance on market forces; evidences regarding sovereign debt; the relationship between market discipline and financial regulation; and soft budget constraints in socialist countries.⁵⁴ He discovered that in the diverse cases examined, the conditions required for market discipline are essentially the same — competitiveness of capital markets; availability of information on the borrower's outstanding liabilities; no expectation for bailout; and the borrower's capability and willingness to respond to market signals provided by interest rate spreads. Because these conditions, especially the “no-bailout” condition cannot always be satisfied, Lane recommended reinforcing market discipline by some kind of direct controls or rules, stressing the importance of implementing measures to strengthen market discipline itself.

Jonas Kornai, who has done thorough studies on post-socialist economies, used the term “financial discipline” synonymously with market discipline. He defined financial discipline as the enforcement of four simple rules, namely: buyers pay for the goods they buy; debtors abide by the loan contract and pay back debt; taxpayers pay their taxes; enterprises cover their costs out of their revenues. Although these rules were self-evident in a market economy, Kornai acknowledged they were far from obvious in a socialist command economy — characterized with soft budget constraints. After analyzing Hungary's experiences in introducing these new rules, he made two conclusions: first, a range of prior conditions must be satisfied before the

⁵² Basle Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards* (July 1988).

⁵³ See, e.g., International Banker, ‘Basle To Keep Partial Modeling’, available at ‘1999 WL 5992038’.

⁵⁴ See generally Lane, Timothy D., *Market Discipline*, the IMF working paper WP/92/42 (June 1992).

financial discipline can be firmly imposed; and second, a quite long period must pass before the actors in the economy believe that financial discipline is being imposed.⁵⁵

2. Market Discipline as a Mechanism to Curb Unsustainable Borrowing and Its Conditions

Unsustainable borrowing, *i.e.*, borrowing without the means or even the intention of repaying, directly leads to NPLs. Market discipline is one force that may limit such abuse of financial markets: market discipline implies that lenders penalize excessive borrowing, first, by requiring a higher interest rate spread and, ultimately, by excluding the borrower from the market.⁵⁶ Lardy expands the lender's discipline function to the time after the funds are lent: Once funds are lent, the lender monitors the borrower to ensure that the use of funds is consistent with the loan contract. Most importantly, he can force the defaulted borrower either to restructure in order to survive or to exit.⁵⁷ If market discipline works effectively, credit will be hardened and hence unsustainable borrowing can be efficiently curbed.

Market discipline will not work for itself, however. As mentioned above, there are four conditions for market discipline to work effectively. Failure of any of these conditions will lead to the failure of market discipline.⁵⁸

Competitive Capital Markets This is required so that unsustainable borrowing will face the borrower with increased interest rates or exclusion from the market. In the case of financial institutions, if there are legal restrictions that limit competition for deposits, such as geographic scope of activities, or if there are activities permitted to particular categories of institutions that gives them a degree of market power, the market's ability to discriminate between prudent and imprudent financial intermediaries will be reduced and thereby market discipline will be rendered ineffective. In the case of SOEs in reforming socialist economies such as China, if financial institutions are directed by the authorities to lend to particular enterprises regardless of their credit-worthiness, financial discipline will be nullified.

Information A second requirement for effective market discipline is to allow lenders to obtain relevant information about the borrower's outstanding debts. The information problem has

⁵⁵ See, *e.g.*, Kornai, Janos, *supra* note 41, at, 141-60.

⁵⁶ See Lane, Timothy D., *supra* note 54.

⁵⁷ See Lardy, Nicolas R., *supra* note 17, at 59-60.

been studied extensively after the burst of the Asian financial crisis. The IMF, in a report about the Asian financial crisis, concluded that the weakness in disclosure practices in the "Asian crisis countries" allowed excessive risk-taking.⁵⁹ Andrew Sheng, the Chairman of Hong Kong Securities and Future Commission summarized the information problem as "Bad accounting = bad information = poor decision-making = bad risk management = financial crisis".⁶⁰ In the case of SOEs in socialist economies, the need for timely information to assess enterprises' credit-worthiness is always frustrated by the unavailability of necessary information and the incapability of bank loan officers to find and process the relevant information.

No Bailout For market discipline to be effective, it is necessary that there is no anticipation of a bailout in the case of (actual or impending) default. This condition is the most crucial and its failure is probably the most important reason for the failure of market discipline. In formerly planned economies, even as reforms proceed, banks are often content to continue lending to insolvent enterprises in the belief that the government will make good on the loans. To be worse, even if the government would like to promote efficiency by committing itself not to bail out insolvent enterprises, such a commitment may not be credible. Once a large enterprise's failure is impending, the government's best response, in view of the possible losses of output and employment, may be to bail out the enterprise.⁶¹

Borrower's Response Market discipline takes two forms: initially, the borrower faces a rising interest rate spread and eventually access to further credit is denied. Because the second stage is often associated with a financial crisis, it is not a normal form of market discipline. Thus, a condition for the smooth operation of market discipline is that borrowers respond to market signals in time to avoid a crisis.

Borrowers who believe that there is a high probability of insolvency, however, will not respond to market signals or to anticipate them: they have nothing to lose by borrowing, even at a high interest rate.⁶² In other words, market discipline does not work through interest rate spread

⁵⁸ See Bishop, Graham, Dirk Damrau, and Michelle Miller, *1992 and Beyond: Market Discipline CAN Work in the EC Monetary Union* (1992); and Frenkel, Jacob A., & Goldstein, Morris, 'Monetary Policy in an Emerging European Economic and Monetary Union', 38 *IMF Staff Papers* No. 2, 356 (June 1991).

⁵⁹ See Balino, Tomas J. T., Enoch Charles *et al.*, *Financial Sector Crisis and Restructuring Lessons from Asia*, 21 (the IMF, September 1999).

⁶⁰ See Andrew, Sheng, *supra* note 1, at 161-2.

⁶¹ See Schaffer, Mark E., 'The Credible-Commitment Problem in the Center-Enterprise Relationship', 13 *Journal of Comparative Economics* No. 3, 359 (September 1989); and also Hardy, Daniel, *Soft Budget Constraints, Firm Commitments, and the Social Safety Net*, IMF Working Paper WP/91/98 (October 1991).

⁶² This is the problem of adverse selection, which has been used as a basis of an explanation of credit rationing in private credit markets. See Stiglitz, Joseph & Weiss, Andrew, 'Credit Rationing in Markets with Imperfect

if borrowers are already near insolvency, it can only work by excluding insolvency borrowers from the market.

C. FAILURE OF MARKET DISCIPLINE — THE ULTIMATE ROOT OF THE NPL PROBLEM IN CHINA

Applying the theory of soft budget constraints and market discipline to China, if budget constraints were hardened, and market discipline were working effectively, State banks would not lend to SOEs unless they are ensured that borrowers are willing to and capable of repaying loan interest and principle. On the other hand, hard budget constraints and market discipline on SOEs would prevent them from borrowing to finance loss-making productive activities that are never expected to turn profitable. A well functioning market discipline could thus prevent the creation of NPLs, or at least reduce the amount of NPLs to an acceptable level. The huge amount of NPLs with State banks, therefore, provide evidence that market discipline is not working effectively in China, and soft budget constraints still apply to SOEs. The veracity of this assumption will be tested in the next section.

IV. CAUSES OF BANK NPLS — EMPIRICAL ANALYSES

A. BANK-CENTRIC AND STATE-BANK-DOMINATED FINANCIAL SYSTEM

1. The Bank-Centric Finance in China

China is still in the stage of bank-centric finance.⁶³ Bank lending — often directed by government policy — dominates enterprise finance, and bank deposits dominate household investment.

Various reasons can be attributed to the bank-centric finance in China.⁶⁴ The most important one is that the bank-centric finance, because it can be instituted and controlled from

Information', 73 *American Economic Review* No. 3, 393 (June 1981). The restrictions on large exposure can be reasoned on this ground as well.

⁶³ For definitions and description of bank-centric finance and market-centric finance, see, e.g., Mellyn & Saal, 'A Perspective on the Risk and Regulatory Implications of Market-Centric Financial Systems', *the First Price Essay of the 1998 Essay Competition of the IIF*.

above, fits the need of the Chinese government to direct savings from the household sector into the financing of industrial development and infrastructure.⁶⁵ The relatively small role of capital markets is not purely a product of market forces; it is also a product of administrative decree. The authorities, fearing that unrestrained capital market development would drain resources from State commercial banks, used credit plans to set quotas on how much equity and securitized debts can be issued in a given year.⁶⁶

(i) *Underdeveloped Capital Markets*

It was not until 1981 that China's Central Government restarted selling treasury bills and other types of government bonds. SOEs, investment companies, and State-owned financial institutions were authorized to sell bonds beginning in 1986. But markets for these debt instruments developed extremely slowly. From 1987 to 1995, the value of all bond issues in a year had never exceeded 20% of the total value of investment by State-owned units.⁶⁷ Enterprise bond issues have been especially small.⁶⁸ Between 1995 and 1997, the annual value of enterprise bond issues accounted for less than 3% of the total enterprise finance (see Table 1.2).

The stock markets were created in the 1980s when provincial legislatures began to experiment with company regulations, and locally chartered companies began to issue shares to sell to the public.⁶⁹ Two stock exchanges — Shanghai Stock Exchange and Shenzhen Stock Exchange opened in 1990 and 1991 respectively. In 1998, the issuance of stock accounted for 15% of the country's total amount of financing raised annually.⁷⁰ According to the latest

⁶⁴ For a detailed discussion about the reasons, see generally Statistics Department of the PBOC, 'An Analysis of the Direct Finance of Chinese Enterprises', *China Finance (Beijing)* No. 9, 24 (1998).

⁶⁵ China has aimed at establishing a bank-centric financial system since the economic reform. See generally Liu, Hongru, 'Developments in the Reform of China's Banking and Financial System', 2 *J. Chinese L.* 323 (Fall, 1988).

⁶⁶ See, e.g., *China 2020: Development Challenges in the New Century*, supra note 39, at 33. In 1997, for example, the quota for enterprise convertible bonds was RMB4bn.

It was not until 2000 that the quota assignment for stock issuance was removed. On March 16, 2000, the State Council approved the Procedures of China Securities Regulatory Commission for Examining and Approving Stock Issuance [zhongguo zhengjianhui gupiao faxing hezhun chengxv, approved by the State Council on March 16, 2000]. The new procedures eliminated quota assignment and administrative recommendations.

⁶⁷ *Id.* Figure 3.8.

⁶⁸ Enterprises in China have been allowed to issue bonds only since the latter part of the 1980s.

⁶⁹ See Neoh, Anthony, 'China's Domestic Capital Markets in the New Millennium' (August 21, 2000), available at 'http://www.chinaonline.com/commentary_an...onomics/currentnews/secure/c00082143.asp'.

⁷⁰ See Chinaonline, 'Some Investors Still Bullish On China's Listed Companies', available at 'http://www.chinaonline.com/top_stories/today_b2_99011818.html'.

statistics, there were 1,063 listed companies, and the amount of registered investors numbered more than 55 million at the end of 2000.⁷¹

At the end of November 2000, the total market value of China's securities market exceeded RMB4.6 trillion, accounting for 50% of China's GDP;⁷² while in G-10 countries, the market capitalization of their stock markets represent well over 100% of their GDP.⁷³ It is estimated by the World Bank that even if capital markets grow at more than twice the rate of projected GDP growth (in real terms) in China, by 2020 the value of stocks and bonds relative to China's economy would only approach that in India's capital market today (74% of GDP).⁷⁴

Table 1.2: Table of Enterprise Finance Structure in China

	1995		1996		1997	
	Amount (RMBbn)	Percentage to the Enterprise Finance in the Aggregate	Amount (RMBbn)	Percentage to the Enterprise Finance in the Aggregate	Amount (RMBbn)	Percentage to the Enterprise Finance in the Aggregate
Enterprise Finance in the Aggregate	1147.1	100	1345.8	100	1479.5	100
Bank Borrowing	1014	88.4	1114	82.8	1140	77
Share Issues	10.3	0.9	42.5	3.2	127.5	8.7
Bond Issues	21.6	1.9	26.8	2	25	1.7
Commercial Papers	101.2	8.8	162.5	12	186	12.6

Sources: Statistics Department of the PBOC, 'An Analysis of the Direct Finance of Chinese Enterprises', *China Finance (Beijing)* No. 9, 24 (1998).

⁷¹ See Chinaonline, 'China's Securities Market Valued at US\$556.44B' (December 15, 2000), available at '<http://www.chinaonline.com/topstories/001215/1/B200121318.asp>'.

⁷² *Id.*

⁷³ See Neoh, Anthony, *supra* note 69.

(ii) *The Domination of Bank Lending in Enterprise Finance*

In contrast to the underdeveloped capital markets is the dominating role of bank lending in enterprise finance. Bank lending accounted for about 90% of the whole finance in China in 1998.⁷⁵ With regard to enterprise finance, the proportion of bank borrowings accounted for over 80% from 1995 to 1997 (see Table 1.2).

(iii) *The Domination of Bank Deposit Savings in Household Financial Assets*

The bank-centric finance in China is also reflected in the structure of household financial assets. The household financial assets in China, although diversified in recent years, are still dominated with bank deposit savings. In 1997, bank deposit savings accounted for more than 80% of all household financial assets, with securities only accounting for approximately 10%, and cash and other assets less than 10%.⁷⁶

(iv) *High-Leverage Ratio in Enterprises and High-Level of NPLs — a Direct Consequence of the Bank-Centric Finance*

The bank-centric finance often leads to high-leverage ratio in enterprises, especially when it is combined with over-saving. The average debt-asset ratio is currently 65% and 71% respectively for SOEs and collective enterprises.⁷⁷ This means that banks and enterprises are so interwoven that industrial collapse would pull down individual banks and even the entire banking system.

Moreover, a bank-centric finance system easily creates NPLs within its banking sector. Because people leave most of their financial resources in the banks to earn a risk-free return, banks have to lend the money out to make profits. When easy money is flooding to companies and projects such as real estate development, bubbles will be created in the property sector and the stock market, as well as huge over-capacity in the manufacturing sector. Later, when the economy slows down, the bubbles burst, companies are left with large amounts of unsold goods,

⁷⁴ See *China 2020: Development Challenges in the New Century*, *supra* note 39, at 34.

⁷⁵ See, e.g., Jiang, Xuejun & Liu, Yan, 'China's Financial Structures', *China Finance (Beijing)* No. 6, 43 (1998).

⁷⁶ See Statistics Department of the PBOC, *supra* note 64.

⁷⁷ See Wu, Renhong, *supra* note 34. Even the listed companies have very higher debt-asset ratio. The 1997 average debt-asset ratio of Chinese listed industrial companies was 47.7%. See *Chinaonline*, *supra* note 70.

and banks end up with massive amounts of NPLs.⁷⁸ This argument is supported by international experiences that the ratio of NPLs to GDP in bank-centric finance economies are usually higher than that in other countries suffering from a financial crisis.⁷⁹

2. The Domination of State Commercial Banks

(i) *The "Big Four"-dominated Financial System*

The bank-centric finance in China is closely connected to a bank-dominated financial system. In China, the banks' share of financial intermediation is almost nine-tenths, a ratio exceeding that found in almost all other Asian countries.⁸⁰ Further, because virtually all banks in China are state owned, the bank domination in China is reflected in the State bank-domination.

China appears to be an extreme example of the Asian pattern where a few banks loom very large on the financial landscape and competition is thus somewhat very limited.⁸¹ Although a variety of institutions are populating China's financial sector, and there is now a nucleus of potential competition between commercial banks, State commercial banks, especially the "big four", are still dominating the banking sector (see Annex I). The profits of the "big four" accounted for 50% of the profits in China's banking system in 1998.⁸² They hold 68% of the nation's deposits, 77% of all loans, 75% of the country's total assets, and employs 66% of those working in the banking sector.⁸³

At year-end 1996, the assets of China's largest bank, the ICBC were RMB3.6trillion, an amount equivalent to just over half of China's GDP that year. The assets of the CCB, the second largest, were RMB2.1trillion, 30% of GDP. Even by the standard of Asia's bank-dominated

⁷⁸ See, e.g., Pu, Yonghao, 'How to Save China from Oversaving', *Chinaonline* (June 28, 1999), available at 'http://www.chinaonline.com/commentary_analysis/ca_c9062521.html'.

⁷⁹ See the World Bank, *Global Economic Prospects 2000 Report*, 73 (December 1999). That ratio has been 27% in South Korea, 30% in Malaysia, 60% in Thailand, and 25% in Indonesia. In contrast, NPLs in other major emerging market crises (Chile in the early 1980s and Mexico in 1995) were less than 20% of GDP. In the Scandinavian banking crises, NPLs amounted to approximately 5% of GDP. The East Asia's heavy reliance on bank-based financial systems and the high debt-equity ratios of corporations have made the economic distress especially acute. *Id.*

⁸⁰ See Lardy, Nicholas R., *supra* note 17, at 16.

⁸¹ In all "Asian crisis countries", commercial banks dominate the financial system. See Balino, Tomas J.T., Enoch Charles *et al.*, *supra* note 59, 'Box 1. Structure of the Financial System at End-1996' at 19.

⁸² See, e.g., Chinaonline, 'S & P Downgrades Hit China's Big Banks When They Can Least Afford It', available at 'http://www.chinaonline.com/top_stories/top_news_story.html'.

financial systems, these two banks accounted for an unusually high share of credit creation. Malaysia's biggest lender, Malayan Banking had assets of less than 40% of GDP in 1997. The ratio for the biggest Thai bank, Bangkok Bank, was 25%. In contrast, the biggest bank in the U.S., Chase Manhattan, controls assets equal to only 4% of GDP.⁸⁴

(ii) *State Commercial Bank-domination: Captive Finance Markets*

As mentioned above, competitive capital markets are one of the conditions for the well functioning of market discipline. This is required so that unsustainable borrowing will face the borrower with increased interest rates. A bank-dominated financial system is a captive market where households and enterprises are left with very few choices but to deposit their money with banks, no matter how high or low the interest rate is.⁸⁵ In a State bank-dominated financial system, it is hard to expect State banks to operate as genuine commercial banks because they do not face substantial competition.

B. SOFT BUDGET CONSTRAINTS ON SOES IN THE FORM OF POLICY LOANS

All four forms of soft budget existed in China before the economic reform, and to some extent exist today. With the deepening of the economic reform, however, soft credits (mainly in the form of policy loans) are gradually taking the place of other forms.⁸⁶

1. General Introduction

The negative effects of government-directed loans have been recognized worldwide.⁸⁷ It is frequently argued that China's bank NPL problem result from years of bad lending practices, and

⁸³ See, e.g., Chinaonline, 'A Look at Bank Reform in China' (April 14, 1999), available at 'http://www.chinaonline.com/top_stories/breakingnews_b2-99030914-2.html'.

⁸⁴ See Lardy, Nicholas R., *supra* note 17, at, 165-66.

⁸⁵ Anecdotal evidences show that countries with bank-dominated financial systems, such as Japan and China, have been able to sustain high household savings rates, even when real interest rates paid on savings are not very attractive. However, the absence of significant competition from capital markets in such systems typically has led to inefficiency in the allocation of funds and a low rate of return on bank capital. *Id.*, at 10-11.

⁸⁶ See, e.g., Fang, Gang, 'On "Comprehensive State Liabilities": How to Deal with Bank's Bad Assets [lun "guojia zhonghe fuzhai", jianlun ruhe chuli yinghang buliang zhichan]', *Economic Research Journal* No. 5, 11, at 11-2 (May 1999).

is exacerbated by political influences on bank lending or actual policy lending to inefficient, over-leveraged SOEs.⁸⁸ The World Bank, for example, has noted with concern that “state banks are not yet completely free to lend according to commercial criteria”, as “about a third of their investment lending is allocated to projects selected by the State Planning Commission, and the rest is subject to considerable informal government influence, particularly in the provinces”; and “as a result the creditworthiness of borrowers and the commercial viability of projects are often not important considerations in lending decisions.”⁸⁹

Lardy defines policy loans in China as loans extended at the behest of the governmental authorities at the central or local levels rather than as a result of normal commercial bank decision-making.⁹⁰ There are two forms of policy loans in China: policy loans for development purpose, and policy loans to subsidize loss-making SOEs.⁹¹

2. Policy Loans for Development Purpose

Policy loans for development purpose are often referred to as re-lending in China. The PBOC lends to financial institutions, primarily the “big four”. These funds are earmarked to finance specific projects identified by the State Planning Commission.⁹² Granting policy loans for development purpose has been legalized as the obligation of State commercial banks’ since the very beginning of their establishment as specialized State banks. The 1986 Interim Regulations on Bank Administration provide that State specialized banks should lend to enterprises according to State policies and plans.⁹³

⁸⁷ Government directed loans are claimed causes to the financial crisis in Korean and Indonesia. See, e.g., Phillips, Michael M., ‘One by One: A Look at How the Global Finance Crisis Began’, *Wall. St. J. Eur.* 12 (April 29, 1999); Balino, Tomas J. T. & Ubide, Angel, *The Korean Financial Crisis of 1997 — A Strategy of Financial Sector Reform*, IMF working paper WP/99/28 (March 1999); Borenztein, Eduardo & Lee, Jong-Wha, *Credit Allocation and Financial Crisis in Korea*, IMF working paper WP/99/20 (February 1999); and Ehrlich, Craid P. & Lee, Jay K., ‘Governance of Korea’s Chaebols: Role in Crisis, Coming Changes’, *East Asian Executive Reports* 9 (March 15, 1998).

⁸⁸ See Lardy, Nicholas R., *supra* note 17, at 91-2; China Business Information Network, ‘China: ADB: Chinese Banks Need 5-Year Reprieve Before Liberalization’ (April 22, 1999), available at ‘1999 WL 5618989’; and Atkinson, Dan, ‘China Plans Bank Clean-up As Yuan Slides’, *The Guardian (London)* 17 (April 6, 1999).

⁸⁹ See, e.g., *China 2020: Development Challenges in the New Century*, *supra* note 39, at 31.

⁹⁰ See Lardy, Nicholas R., *supra* note 17, at 83.

⁹¹ This division has been used before by other authors. See, e.g., Qian, Yingyi, ‘Financial System Reform in China: Lessons from Japan’s Main Bank System’, in Aoki, Masahiko & Hume Patrick, *The Japanese Main Bank System: Its Relevance for Developing and Transforming Economies* (1994).

⁹² Now the State Development and Planning Commission.

⁹³ Interim Regulations of the People’s Republic of China on Bank Administration, issued by the State Council on January 7, 1986 (hereinafter referred to as “Interim Regulations on Bank Administration”), art. 14.

Policy loans for development purpose have developed with the decentralization of financial resources in China. Under the old system of enterprise finance before the economic reform — known as “uniform collection and unified expenditure”, SOEs returned almost all their profits to the MOF and received investment funds plus a minimum amount of quote working capital in the form of grants from the State-budget.⁹⁴ The PBOC, the mono-bank in China before the reform,⁹⁵ only provided SOEs with credits to finance above-quote working capital.⁹⁶ Soft budgets to SOEs then seldom took the form of bank soft credits.

The economic reform initiated in 1978, however, changed the picture completely. Accompanying the decentralization of decision-making power through the reform,⁹⁷ an increased proportion of the national financial resources started to be held by decentralized units — households, enterprises, and local governments. For example, by 1991 the share of households in total national savings reached 46%. The decentralization of financial resources led to a greater separation of the saver from the investor. As a result, there arose a need for financial intermediaries.⁹⁸ After the 1979-84 banking system reconstruction, a two-tier banking system evolved in China: with the PBOC as the central bank, and four specialized state banks as the second tier.⁹⁹

With more and more financial resources being held by decentralized units, the share of central government revenues of GDP has been decreasing annually.¹⁰⁰ In 1998, the central government revenues were only 12% of GDP — well below the developing country average of

⁹⁴ See Bowles, Paul & Gordon White, *supra* note 46.

⁹⁵ Prior to the reforms financial resources in China were highly centralized. The mobilization and allocation of financial resources was done mainly through the state budget in conjunction with the state plan. Household savings accounted for only 3% whereas the state budget accounted for 46% of total national savings on the eve of the reforms in 1978. Since the government was the main saver and investor, financial intermediaries were neither necessary nor allowed. Hence, financial markets were closed, financial instruments were prohibited, and all financial institutions had been either confiscated or nationalized and were merged with the PBOC. See, e.g., Jao, Y. C., ‘Financial Reform in China and Hong Kong 1987-1988: A Comparative Overview’, Paper presented to the Inaugural International Conference on Asian Pacific Financial Markets (Singapore: 16-18 Nov. 1989).

⁹⁶ See, e.g., Luc, De Wulf, ‘Financial Reform in China’, *Financial & Development* 19 (December 1985).

⁹⁷ For a general discussion of the decentralization in China’s industrial system, see, e.g., Chai, Joseph C. H., *China: Transition to A Market Economy*, Chapters 3 & 4. (1997).

⁹⁸ See generally the World Bank, *World Development Report*, 28-9 (1989).

⁹⁹ See generally Luc, De Wulf, *supra* note 96. For China’s financial system at the end of 1985, see Zhou, Xiaochuan & Zhu, Li, ‘China’s Banking System: Current Status, Perspective on Reform’, *Journal of Comparative Economics* No. 11, 399, Fig. 1: The Structure of China’s Banking System (1987).

¹⁰⁰ Between 1978 and 1995 budgetary revenues tumbled from 35% of GDP to 11%. See *China 2020: Development Challenges in the New Century*, *supra* note 39, at 24.

approximately 32%, making it one of the lowest levels in the world.¹⁰¹ The decline in revenue, combined with the government's desire to keep the budget deficit modest, has brought a similar decline in government expenditures as a share of GDP. Investment suffered the most, falling from 16% of GDP in 1978 to less than 3% in 1995.¹⁰² Starting in 1983, budget financing of working capital for SOEs was drastically curtailed, and in late 1984 the government announced that the budget would no longer provide financing for fixed-asset investments.¹⁰³ Consequently, the expansion of the economy relies heavily on the banking system. In 1995, bank loans accounted for 39% of the government-controlled investment.¹⁰⁴

To free State commercial banks from policy loans for development purpose, three policy banks have been established since January 1994: the State Development Bank (SDB), whose general responsibility is infrastructure lending;¹⁰⁵ the Agricultural Development Bank (ADB), who is responsible for funding agricultural procurement and agricultural infrastructure;¹⁰⁶ and China Export-Import Bank, whose responsibility is to handle export-import financing for key sectors.¹⁰⁷ The establishment of policy banks has to some extent released the "big four" of their policy-lending obligation, as reflected in changes in the magnitude of central bank loans to the "big four". Central bank lending to the "big four" grew from RMB268.2bn in 1985 to over RMB960bn by 1993 and then fell to RMB680bn at year-end 1995 as policy lending began to be channeled through newly-created policy banks in 1994.¹⁰⁸

The policy banks, however, generally lack secure funding sources. For example, most of the SDB's funding has come from low-interest bonds placed with State commercial banks by the

¹⁰¹ More seriously, 60% of the RMB 548.3bn in total central government revenues of 1998 came not from tax collection but from the issuance of debt. Of the debt raised, 70.9% went on servicing and financing redemption of other debts. This seriously impairs the central government's ability to conduct macro-economic policy and pursue a fiscal stimulus policy. See, e.g., Kynge, James, 'China: Poor Revenues Hit Growth Hopes', *Fin. Times* (April 6, 1999).

¹⁰² See *China 2020: Development Challenges in the New Century*, *supra* note 39, Figure 3.1.

¹⁰³ See generally Circular of the State Council Approving and Promulgating the Report of the People's Bank of China on the PBOC's Unified-Management of State-Operated Enterprises' Working Capital, issued by the State Council on June 25, 1983; and Interim Provisions Converting All State Budgetary Capital Construction Investment from Appropriations to Loans, adopted by the MOF on December 14, 1984.

¹⁰⁴ See, e.g., *China 2020: Development Challenges in the New Century*, *supra* note 39, Figure 3.2.

¹⁰⁵ See Circular of the State Council on Establishing the State Development Bank, No. 22, 1994.

¹⁰⁶ See Circular of the State Council on Establishing China Agricultural Development Bank, No. 25, 1994.

¹⁰⁷ The Export-Import Bank of China was formally established on April 26, 1994, and started operations on July 1, 1994. The bank's financial business is subject to the direction and supervision of the MOF, the Ministry of Foreign Trade and Economic Cooperation (MOFTEC) and the PBOC. See Wan, Timothy Haosen, *Development of Banking Law in the Great China Area: PRC and Taiwan*, 181-2 (1999).

¹⁰⁸ See Lardy, Nicholas R., *supra* note 17, at 85.

PBOC fiat, while the ADB relies on the PBOC re-lending for 90% of its needs.¹⁰⁹ Furthermore, policy banks, because of their mandates to lend to state projects for the implementation of state policies, are accumulating NPLs themselves. The ADB, for example, had accumulated RMB214bn NPLs from its establishment to November 1999.¹¹⁰ These institutional weaknesses of young policy banks indicate that it may take a while before they have the resources to shoulder all policy lending. As a result, State commercial banks are still required to conduct their loan business in accordance with the need for the development of the national economy and social progress under the guidance of the State industrial policy.¹¹¹

3. Policy Loans to Subsidize Loss-making SOEs

The situation of policy loans to subsidize loss-making enterprises is more complicated than that of policy loans for development purpose. China's SOEs, while acquiring increased autonomy over their operations since 1980,¹¹² are increasingly under pressures from competition created by trade liberalization and the proliferation of non-state enterprises, and consequently suffer huge losses every year.¹¹³ Their rate of return on assets (measured by pre-tax profits divided by the sum of the depreciated value of fixed assets plus working capital) has been declining during the economic reform, which averaged 24-25% in the early years of reform, and has declined continuously since 1985 while standing at only 6% in 1997.¹¹⁴ As a result, the SOEs' dependence on public subsidies began to increase.¹¹⁵ The decentralized financial resources,

¹⁰⁹ See generally Holmes, William D., 'China's Financial Reforms in the Global Market', 28 *Law & Pol'y Int'l Bus.* 715.

¹¹⁰ See, e.g., Reuters English News Service, 'China: China's WTO Deal Heralds Radical Banking Reform' (November 16, 1999). The ADB funds state grain purchases from farmers at above-market prices. It was estimated that the amount would rise dramatically as cheaper and better foreign agricultural imports flooded the market. *Id.*

¹¹¹ The Law of the People's Republic of China on Commercial Banks, adopted at the 13th Session of the Standing Committee of the 8th National People's Congress on May 10, 1995, and effective as of July 1, 1995 (hereinafter referred to as "the Commercial Banking Law"), art. 34.

¹¹² For a detailed discussion of the SOEs' increasing autonomy through the economic reform, see Chai, Joseph C. H., *supra* note 97, Ch. 4.

¹¹³ Compared to non-state sector enterprises, SOEs have lagged in output, employment, and productivity growth. Their return on assets is estimated at just 6.0%, compared with 8.4% in collectives and 9.9% in joint ventures. Their share of loss-makers was 26% in 1992 and increased to 50% in 1996. See *China 2020: Development Challenges in the New Century*, *supra* note 39, at 28.

¹¹⁴ See, e.g., Lardy, Nicholas R., *supra* note 4, at 17-18.

¹¹⁵ Since the late 1980s, direct fiscal subsidies and indirect subsidies (policy loans) together absorbed 10% or more of GDP every year. See Lardy, Nicholas R., *supra* note 17, at 4.

however, made the government unable and unwilling to subsidize these enterprises by budget.¹¹⁶ Thus, the banking system became the SOEs' main source of financial support.¹¹⁷ In 1994, for example, banks were ordered to lend to subsidize loss-making enterprises so as to maintain the life of those SOEs' employees and the stability of the society.¹¹⁸

Some of the subsidizing policy loans are actually subsidies to enterprises that are suffering losses because of government policies and the cost of their social security benefits.¹¹⁹ To contract the scope of subsidies, at the 14th Session of the 8th NPC in March 1996, the government announced its intention to concentrate on the reform and development of 1,000 large SOEs and state-owned enterprises groups that would form the core of China's modern enterprise system.¹²⁰ The central government also determined that continued policy loans, tax relief, additional credit, and sales support would be used to support these 1,000 core enterprises and enterprise groups, while the rest of the SOEs would be left for restructuring, mergers, leasing, sale to non-state enterprises, or bankruptcy.¹²¹ Consequently, the State commercial banks' lending mission was narrowed to a small population of eligible SOEs by the adoption of the main bank system. Adopting the Japanese model, each borrower is paired with a main bank lender — actually a designated bank branch — with which it keeps its basic account and from which it receives all of its loans (unless the main bank is unable to meet its demand). Three hundred large and medium-sized SOEs were paired with main banks as the first step to adopting the main bank system.¹²² As a result, 80% of new loans went to these 300 SOEs in the first half of 1996.¹²³

In addition to policy loans subsidizing enterprises suffering losses because of government policy, there are also loans made under informal government intervention. Local governments at various levels, especially provincial governments, fearing large lay-offs from the failure of loss-making enterprises, have pressured state banks to keep lending to loss-making enterprises. And

¹¹⁶ E.g., budgetary subsidies fell from 7.5% of GDP in 1992 to 2.3% in 1994. See the World Bank, *The Chinese Economy: Fighting Inflation, Deepening Reforms*, 17, a World Bank Country Survey (1996).

¹¹⁷ Despite recent attempts of reform, China's banks are still the dispensers of disguised subsidies, in the form of loans, to unprofitable SOEs. In 1994, for example, implicit financial subsidies in the form of low interest rate loans and unpaid principal and interest came to 1.7% of GDP. *Id.*

¹¹⁸ The Urgent Circular on Making Working Capital Loans to SOEs, PBOC No. 34 (1994).

¹¹⁹ For example, in 1994, a survey of 156 SOEs showed that the budgetary and financial subsidies received equaled the costs to enterprises arising from government price policies, social securities benefits, and wages for redundant workers. See the World Bank, *supra* note 116.

¹²⁰ *Id.*, and *China 2020: Development Challenges in the New Century*, *supra* note 39, at 29-30.

¹²¹ See, e.g., Miller, Sheryl, 'Institutional Impediments to the Enforcement of China's Bankruptcy Laws', 8 *Int'l Legal Persp.* 187.

¹²² This system is set out in the Provisional Measures for Main Bank Management, issued by the PBOC on June 29, 1996, effective as of July 1, 1996.

they were well-positioned to make interventions, because the PBOC and the “big four” had thousands of regional and local branch offices that were under dual administration by their headquarters and the regional or local governments.¹²⁴ Under such an administrative structure, even if the Commercial Banking Law grants banking institutions autonomy to make lending decisions and prohibits any individual or entity from forcing the bank to make lending or provide a guarantee,¹²⁵ the banks’ autonomy cannot be guaranteed.¹²⁶ According to Moody, in the first half of 1999, 89% of State bank lending was to state-sector companies in spite of their poor performance.¹²⁷

4. Failure of Market Discipline Due to Policy Loans

As a kind of soft budget constraints to SOEs, policy loans result in SOEs’ irresponsiveness to market signals¹²⁸ and lack of dynamic capacity. The pervasiveness of policy loans also deepened the captivity of China’s financial markets. Making matters worse, because banks are subject to government mandate and intervention in their lending activities, the need for the development of the micro-credit analysis structure in the banking industry has been delayed and masked — resulting in weak internal controls, especially weak risk-control systems. All these lead to the failure of market discipline in preventing unsustainable borrowing in China and consequently result in the accumulation of NPLs on State commercial banks’ books.

¹²³ See Holmes, William D., *supra* note 109.

¹²⁴ China’s Central Bank was an immense institution with branches in every provincial level administrative unit and offices in all larger cities as well as most counties before the 1998 structural reshuffle. By mid-1993, the provincial branches of the PBOC responded primarily to provincial-level political leaders rather than the PBOC headquarters in Beijing. This was not surprising since the control of appointments of the top officials in each provincial branch of the central bank was largely in the hands of provincial party officials rather than in the hands of the central bank headquarters in Beijing. In turn, the provincial branches of the four specialized banks, as to a lesser degree than other banks, were responsive primarily to the policies emanating from the provincial branches of the central bank rather than their own head offices in Beijing. This structure maximized the possibility that loan decisions within each province would be response to local political pressure and even corruption. See Lardy, Nicholas R., *supra* note 17, at 90-1.

¹²⁵ The Commercial Banking Law, *supra* note 111, art. 41; and also General Lending Rules, issued by the PBOC in 1995 and effective as of August 1, 1996, art. 22, which provides lender’s right.

¹²⁶ This is indicated in one signed article by a CCB official published on *Zhongguo Jingrong (China Finance)*, a monthly Journal of the PBOC, where the author suggests that regional and local branch should avoid and resist making policy loans imposed by local governments with flexible strategy and tactics and try to win over their understanding and support. See Song, Bo, ‘Proposals on the Commercial Bank’s NPL Workout’, *China Finance (Beijing)* No. 1, 23 (1998).

¹²⁷ See, e.g., Kynge, James, ‘Beijing: China Bank Reform “Yet to Tackle All Faults”’, *Fin. Times* (August 18, 1999).

Given China's desperate need to keep its economic growth,¹²⁹ it is predictable that policy loans cannot be ended abruptly. Dai Xianglong announced at the World Economic Forum in Beijing in April 1999 that the "big four" would end policy loans to bail out government businesses within two years.¹³⁰ This might be a realistic commitment.

C. ADMINISTRATIVE CONTROLS ON STATE COMMERCIAL BANKS

1. Administrative Controls on State Commercial Banks as Monetary Policy Instruments

China's bank-centric finance has determined that banks must play an important role in accumulating and distributing funds. This, together with the central bank's inability to use indirect monetary policy instruments, results in administrative controls on commercial banks such as credit plans and interest rate controls,¹³¹ although these direct instruments have not always proven very effective.¹³²

The PBOC's over-reliance on direct monetary policy instruments evolved from the pre-reform period. From 1953 to 1978, the State controlled the supply of credit and cash through a credit and cash plan.¹³³ The credit plan was to provide working capital for industry and commerce, while the cash plan was designed to control demand and to facilitate transactions in consumer goods markets.¹³⁴ The PBOC followed cash and credit plans from the State Planning Commission, and its branches provided financial resources to enterprises according to the plan.

¹²⁸ According to a survey in 1992, enterprises' demands for bank loans were not very responsive to changes in interest rates. See Chai, Joseph C. H., *supra* note 97, Table 5.3.

¹²⁹ It is predicted that serious socio-economic problems will result if China's growth rate falls below 7%. See generally Chinaonline, 'China Should Set Economic Growth Rate Floor at 7%, Economist Says' (May 7, 1999), available at http://www.chinaonline.com/top_stories/breakingnews_b2-99050518.

¹³⁰ Quoted in Callick, Rowan, 'China Draws Near to WTO Membership', *Australia Financial Review* 15 (April 28, 1999).

¹³¹ Zhao, Ziyang, China's former premier minister, stated in his report to the 13th National Congress of the CPC that the government should intensify the reform of China's monetary system, strengthen the status of banks and their role in the system of macro-economic control, and exercise proper control over the volume of credit funds supplied in accordance with sound policies relating to currency circulation. See Liu, Hongru, *supra* note 65.

¹³² For example, broad money maintained its rapid expansion in 1995 on the strength of rising foreign reserves and higher-than expected growth in domestic credit, as State commercial banks found new ways to circumvent the credit plan. See the World Bank, *supra* note 116.

¹³³ Before 1953, cash management was the centerpiece of monetary policy. See generally Dai Genyou, 'A Review of PBOC's Monetary and Credit Policy', *China Finance (Beijing)* No. 12, 27 (1999).

¹³⁴ See, e.g., Fernando, Montes-Negret, 'China's Credit Plan: An Overview', 11 *Oxford Rev. of Econ. Pol'y* No. 4, 25 (Winter, 1995).

In 1978, the PBOC was separated from the MOF and granted ministerial rank.¹³⁵ Five years later, in 1983, the State Council granted the PBOC the authority of a central bank and the PBOC subsequently transferred its commercial banking operations to four specialized banks.¹³⁶ The PBOC was authorized to take the responsibility for making and implementing monetary policy via credit plans and interest rate controls, among other means.¹³⁷ This responsibility was confirmed in the 1986 Interim Regulations on Bank Administration.¹³⁸

2. The Credit Plan

(i) *General Introduction.*

The financial system in China had implemented the “credit plan” format until 1998 — the central bank regulated supply and allocation of credit through an annual credit plan.¹³⁹ The credit plan governed each bank’s credit volume directly (in the aggregate, by different types of lending, and sometimes by different sectors, sub-sectors, and even individual borrowers¹⁴⁰) and translated the government’s investment plans into reality.¹⁴¹

The PBOC implemented the credit plan by imposing individual credit ceilings on the State specialized banks, and later on other commercial banks and non-bank financial institutions.¹⁴² After formulating an annual credit plan, the PBOC allocated credit ceilings to

¹³⁵ See Gang, Yi, *Money, Banking, and Financial Markets In China*, 27 (Beijing: 1994).

¹³⁶ See Decisions of the State Council on the PBOC’s Exclusive Role as Central Bank, issued by the State Council on September 17, 1983 (hereinafter referred to as “the Decisions on the PBOC’s Exclusive Role as Central Bank”).

¹³⁷ *Id.* art. 1

¹³⁸ Interim Regulations on Bank Administration, *supra* note 93, art. 5.

¹³⁹ See, e.g., Chai, J. C. H., ‘Domestic Money and Banking Reform in China’, *Hong Kong Economic Papers*, No. 14, 37 (1981).

¹⁴⁰ Separate credit ceilings were set for different categories of bank credits. There were three categories of bank loans: working capital credits (up to 1 year), technical renovation or transformation credits (1-5 years), and fixed capital construction loans (between 5-10 years). Each maturity category was further broken down into activities, sub-sectors, and major projects. Working capital loans, for example, were subcategorized as loans for the construction industry, industry and commerce, technological development, local suppliers of equipment and inputs, special purposes, housing, bridges, and capital construction reserve fund. Some flexibility was allowed: the specialized banks could reallocate their “quota” from fixed asset lending to working capital loans, for example, but could not do the reverse. See Fernando, Montes-Negret, *supra* note 134.

¹⁴¹ See the World Bank, *supra* note 116, at 28. For a detailed description of the process to formulate an annual credit plan, see the World Bank, *infra* note 142, at 37-8; and Fernando, Montes-Negret, *supra* note 134.

¹⁴² Since its creation, the credit plan had been expanding its application in an intention to counter credit plan leakage. The plan originally did not applied to non-bank financial institutions. In 1988, there were great leakages from the credit plan, primarily through a rapid expansion of loans by non-bank financial intermediaries. As a result, inflation began to accelerate in 1988. The PBOC had to institute a broader credit plan beginning in March 1989.

each state bank's head office and to the PBOC branches in Shanghai and Shenzhen. In turn, the banks allocated credit ceilings to their branches, with the exception of the branches in Shanghai and Shenzhen, which received their credit ceilings from the local PBOC branch. These ceilings were afterwards monitored by the local PBOC branches and were binding on the overall operations of each bank and on their respective branch offices. Swapping of credit ceilings between branches whose loan demands were below the ceilings and those whose loan demands exceeded the ceilings was not permitted.¹⁴³

(ii) *Negative Effects of the Credit Plan*

Under the credit plan, banks were actually facing a captive market, where they had no choice but to lend to designated borrowers. For example, under the credit ceilings set in the early 1990s for the largest specialized bank, the ICBC, about a third of lending was mandatory loans for key economic sectors, another third was fixed asset loans, and another 10% was committed to specific projects of local governments. Thus, less than 20% of the bank's lending was decided "autonomously".

Moreover, banks under the credit plan acted largely as passive channels, allocating credit to priority sectors, sub-sectors, and projects selected by national or local governments. As passive financial agencies of the government, they did not need to manage their risks.¹⁴⁴ This resulted in their weak internal controls (especially risk-management ability). The lack of risk-management ability was evident in the sharp reduction in new loans in the first quarter of 1998. When the credit ceilings on banks were removed in 1998, banks were forced to cut their lending because they could not evaluate the risk of some projects properly.¹⁴⁵

3. Interest Rate Controls

Under the credit plan in the broader sense, all lending institutions, including credit cooperatives, trust and investment companies, and other non-bank financial intermediaries were subject to credit ceilings. See the World Bank, *China: Financial Sector Policies and Institutional Development*, 31-2, a World Bank Country Study (1990).

¹⁴³ *Id.*, at 38.

¹⁴⁴ E.g., in South Korea, beginning in the early 1980s, the government involvement in bank lending decisions was gradually reduced. But banks developed few skills in credit analysis or risk management, lending decisions were still largely based on the availability of collateral rather than on an assessment of risk and future repayment capacity. See Balino, Tomas J. T., Enoch Charles *et al.*, *supra* note 59, at 20.

¹⁴⁵ See, e.g., Liu, Bin (Statistics Department of the PBOC), 'A Survey on the Loan Extending Behavior of Chinese Commercial Banks', *China Finance (Beijing)* No. 9, 27 (1998).

(i) *The Development of Interest Rate Controls*

Interest rate controls have been a dominant feature of China's financial system. Before the economic reform, bank interest rates in China remained at low levels with very few brackets and were always fixed for long periods of time.¹⁴⁶ Since the reform began, the interest rate policy has gone through adjustments that have enabled interest rates to function as a lever in regulating the supply and demand for funds.¹⁴⁷ Interest rates continued to be set administratively by the PBOC, however, subject to the approval of the State Council. The 1986 Interim Regulations on Bank Administration provided that, except for inter-bank lending interest rates,¹⁴⁸ interest rates should be set by the PBOC headquarters.¹⁴⁹ In December 1990, the PBOC promulgated Interim Provisions on Interest Rate Administration, providing procedures for the PBOC to fix and administer RMB interest rates.¹⁵⁰

The 1995 Commercial Banking Law, while providing that commercial banks shall operate and assume civil responsibilities independently,¹⁵¹ reiterates that they shall fix their interest rates for deposit and loans pursuant to the ceiling and floor interest rates defined by the PBOC.¹⁵² On March 2, 1999, the PBOC issued its new Provisions on RMB Interest Rate Administration.¹⁵³ These Provisions grant financial institutions a little bit more freedom in deciding interest rates, but banks are still required to fix their deposit and loan interest rates pursuant to the ceiling and floor interest rates set by the PBOC.¹⁵⁴

(ii) *The Negative Effects of Interest Rate Control*

¹⁴⁶ See Liu, Hongru, *supra* note 65.

¹⁴⁷ *Id.*

¹⁴⁸ Interim Regulations on Bank Administration, *supra* note 93, art. 45. This article authorizes State specialized banks to decide the inter-bank lending interest rates.

¹⁴⁹ *Id.* art. 42.

¹⁵⁰ Interim Provisions on Interest Rate Administration [lilv guanli zhanxing guiding], issued by the PBOC in December 1990.

¹⁵¹ The Commercial Banking Law, *supra* note 111, art. 4.

¹⁵² *Id.* arts. 31 & 38.

¹⁵³ Provisions on RMB Interest Rate Administration [renminbi lilv guanli guiding], promulgated by the PBOC on March 2, 1999, effective as of April 1, 1999.

¹⁵⁴ *Id.* arts. 5 & 6.

Among all administrative restrictions, interest rate controls do the greatest harm to the well functioning of market discipline. With interest rates being set administratively by the PBOC, sometimes at a very low level to subsidize the development of certain priority industries or loss-making enterprises,¹⁵⁵ commercial banks have no way to discipline unsustainable borrowers by charging higher lending rates. Actually, even under the floating rate system, banks are not allowed to raise their lending rates when they lend to large SOEs. In the September 1999 widening of rate floating for lending to small- and medium-sized enterprises, the PBOC clearly stated that lending rates for loans to the 512 key SOEs could not be floated upward.¹⁵⁶

Making matters worse, because of the administrative control, bank interest rates sometimes give distorted signals to the market. According to a 1996 World Bank report, China's interest rate policy "fulfills a complex set of objectives, reflecting the authorities' 'revealed preferences' with respect to distribution of subsidies to various productive activities, groups and regions; policies for industrial and agricultural development; and resource transfer from depositors to the state or other borrowers."¹⁵⁷

Further, because of the government's intention to use higher interest rates to mobilize savings while at the same time providing cheap credit to enterprises, the interest margin received by China's commercial banks is narrow and sometimes even negative.¹⁵⁸ Over time, the result has been a steady de-capitalization of the banks.¹⁵⁹ Making matters worse, there is no sign that the government will discontinue its policy to sacrifice the banks for economic growth. For example, to stimulate the economic growth, interest rates were cut consecutively seven times from May 1996 to July 1999 (see Annex II), reducing interest rate margins of Chinese banks by 0.9 percentage points.¹⁶⁰

4. Division of Business Scope among State Specialized Banks

¹⁵⁵ There were more than 30 preferential rates around 1995. See, e.g., Mehran, Hassanali, Laurens, Bernard & Quintyn Marc (eds.), *Interest Rate Liberalization and Money Market Development*, 19 (1996).

¹⁵⁶ See Zhou Rongfan, Chao Deyun, 'The Reform and Development of China's Floating Interest Rate System' [woguo fudong lilv zhidu de gaige he fazhan], *China Finance* No. 10, 23, at 24 (1998). The PBOC also prohibited individual housing loans, preferential loans and loans from policy banks from floating.

¹⁵⁷ See the World Bank, *supra* note 142, at 24.

¹⁵⁸ See, e.g., Chinaonline, 'China's Central Banker Talks up Bank, Interest Rate Reform' (October 12, 1999), available at '<http://www.chinaonline.com/topstories/C9101109.asp>'.

¹⁵⁹ See, e.g., *China 2020: Development Challenges in the New Century*, *supra* note 39.

¹⁶⁰ See Dai Xianglong, 'Improve Financial Services to Assist Reform and Progress of SOEs in Accordance with the Guideline of the 4th Plenary of the 15th Central Committee of CPC', *China Finance*, No. 11, 4, at 5 (November 1999).

(i) *The Development of Business Scope Division among State Specialized Banks*

Each of the “big four” was authorized to operate in certain specific sectors of the economy when it was established or reestablished. When the ABC was re-established in 1979, it operated mainly in the rural sectors with responsibility for rural financial affairs.¹⁶¹ The ICBC was established in 1984 and handled mainly the domestic currency business of state enterprises in the urban industrial and commercial sectors.¹⁶² The BOC acquired its independent status in 1979 and was mainly responsible for foreign exchange business.¹⁶³ The CCB also became part of the specialized banking system in 1979¹⁶⁴ and was mainly responsible for the disbursing and control of funds budgeted for basic construction and modernization investment.¹⁶⁵ In 1983, the State Council promulgated Decisions on the PBOC's Exclusive Role as Central Bank, authorizing the PBOC to further specify and adjust the business scope division among specialized banks.¹⁶⁶ In 1984, the State Council approved the PBOC's report dividing the business scope among specialized banks regarding fixed-asset loans.¹⁶⁷

The division of business scope among specialized banks did not last long. Although the 1986 Interim Regulations on Bank Administration confirmed this business scope division by providing that state specialized banks must apply for the approval of the PBOC for activities

¹⁶¹ See, e.g., He, Linxiang (Governor of the ABC), 'ABC Pressing Forward in China's Reform and Opening up', *China Finance (Beijing)* No. 8, 4 (1998).

¹⁶² See, e.g., Liu, Tinghuan (Governor of the ICBC), 'ICBC's 20 Years of Reform and Development', *China Finance (Beijing)* No. 7, 7 (1998).

¹⁶³ See Reply of the State Council to the PBOC's Proposal Concerning the Amendments to the BOC's Articles of Association. Issued by the State Council on September 22, 1980.

¹⁶⁴ The predecessor of the CCB is the People's Construction Bank of China (PCBC), which was first established in 1954 under the Decision of the State Council on Establishing the People's Construction Bank of China, as a specialized bank subject to the Ministry of Finance to supervise the use of public money for capital construction. In 1979, the PCBC became subject directly to the State Council and began to involve itself in banking business. The PCBC started to take deposits from enterprises and use them to extend long-term credits to finance both basic construction and modernization investment in 1980; started its cash booking business and working capital loans business in 1984; and started to take household deposit and savings in 1985. The PCBC has been renamed as CCB since March 26, 1996. See CCB, 'CCB Is Enjoying A Rapid Development And Undertaking A Strategic Reform', *China Finance (Beijing)* No. 8, 9 (1998).

¹⁶⁵ In 1983, the State Council promulgated Decisions on the PBOC's Exclusive Role as Central Bank. The Decisions provide that CCB should concentrate on issuing grants and loans for capital construction and loans for large-sized technical updating and transformation projects. The PBOC should transfer its business of loans for capital construction to CCB, while CCB should transfer its business of loans for medium and small-sized technical updating and transformation to the ICBC. The Decisions on the PBOC's Exclusive Role as Central Bank, *supra* note 136.

¹⁶⁶ *Id.* art. 3.

beyond their authorized business scope,¹⁶⁸ since 1985, all four specialized banks have been allowed to undertake general banking business irrespective of their sector, and compete for deposits and loans in their previously monopolized markets.¹⁶⁹ The 1993 Resolution of State Council on Financial Reform provided that there should be overlap between State commercial banks' business, and competition between State commercial banks should be encouraged.¹⁷⁰ The division was formally removed by the 1995 Commercial Banking Law.¹⁷¹

(ii) *The Negative Effects of the Business Division*

The administrative division of business scope between the four state specialized banks had seriously impeded competition between banks. Under the division, specialized banks' clientele was limited to certain geographic areas and/or industries, facing them with captive markets. Although the division only existed shortly, its influence still exists. Given the structure of the banks' preexisting branch networks and the informal limitations on competition that continue to prevail, full overlap has yet to take place.

D. WEAK INTERNAL CONTROL SYSTEMS IN STATE COMMERCIAL BANKS

Banks under heavy administrative controls often do not have the opportunity to develop their risk-management capacity. In Japan, for example, tight controls of bank behavior by regulators had long been a substitute for risk management by banks and for monitoring by shareholders and depositors. When the controls were successively relaxed in the 1970s and 1980s, a vacuum emerged in bank risk management.¹⁷² This might have been a factor behind massive lending into real estate-related activities of Japanese banks in the 1980s, where credit analysis was just a

¹⁶⁷ See Report of the PBOC Concerning the Division of Business Scope in Fixed Asset Loans among Specialized Banks, approved by the State Council on May 13, 1984.

¹⁶⁸ Interim Regulations on Bank Administration, *supra* note 93, art.16.

¹⁶⁹ See Qian, Yingyi, *supra* note 91.

¹⁷⁰ Section 3, Resolution on Financial Reform, State Council, No. 91 (1993).

¹⁷¹ The Commercial Banking Law, not like the 1986 Interim Regulations on Bank Administration, has no special provisions for the former "big four" state specialized banks, they are treated equally in the law with other commercial banks.

¹⁷² Even as of 1996, banks were reluctant to go ahead with self-assessment of their loan portfolio, because, in their view, this would involve much preparation on their part. See Ueda, Kazuo, 'The Japanese Banking Crisis in the 1990s' in *Strengthening the Banking System in China: Issues and Experience*, BIS Policy Papers No. 7, 251, at 259 and note 7 (October 1999).

matter of estimating the future path of real estate prices.¹⁷³ This is exactly the case for Chinese banks (especially State commercial banks). After decades of extending loans largely at the behest of political leaders, the banks have not accumulated sufficient experience in real commercial banking.¹⁷⁴

According to a 1996 World Bank report about China,¹⁷⁵ China's State commercial banks are handicapped by such operational deficiencies as the absence of key management processes (planning, budgeting, reporting); lack of familiarity with asset and liability management techniques; inadequate accounting standards that render performance and risk assessment difficulties; substandard information systems; inappropriate internal incentives systems for staff; and poorly articulated institutional structures and legal frameworks. These are needed to underpin a sound system of corporate governance, eliminate interference and conflicts of interest, increase management autonomy, and protect the interests of owners and depositors.

These weak internal controls led to the accumulation of NPLs.¹⁷⁶ A survey conducted at the end of 1998 divided the loan assets in one of the "big four" into loans under credit plans or government instruction, and loans granted at the full discretion of the bank. It discovered that more NPLs were created via lending at the full discretion of the bank, both in absolute amount and in proportion, than were created via lending under credit plans or government instructions.¹⁷⁷ The PBOC launched an inspection at the end of 1998 into 50 branches of state banks where there had been sharp increases in bad debts and found serious problems including "chaotic" internal management, "blind lending", falsifying NPL data, severe dereliction of duty and "fraud for self-interest".¹⁷⁸ More seriously, weak internal controls have led to numerous instances of corruption and fraud by bank officials,¹⁷⁹ as well as misdemeanors by bank managers.¹⁸⁰

¹⁷³ *Id.*, at 256.

¹⁷⁴ A senior partner in Price Waterhouse was reported saying "China's bankers are still ill-equipped to evaluate the quality of new loans". See 'Long and Slow Road Ahead for Banking System Reform', *Hong Kong Standard* (January 31, 1997).

¹⁷⁵ See the World Bank, *supra* note 116, at 34-35.

¹⁷⁶ See, e.g., Wang, Zhaoxing, 'Financial Supervision: Opportunities and Challenge [jinrong jianguan: fanzhang yu tiaozhan]', *China Finance* No. 12, 16, at 18 (December 1999); and also Kang, Shusheng, *Commercial Banks' Internal Controls: Borrowing and Innovation [shangye yinhang neikong zhidu: jiejian yu chuangxing]*, 3 (1999).

¹⁷⁷ See, e.g., Zhang, Haining & Ouyan, Haijie, 'How Can State Commercial Banks Prevent Credit Risks [guoyou shangye yinhang fangfan xingdai fenxiang de chulv zai nali?]', *China Finance (Beijing)* No. 10, 34, at 34 (1999).

¹⁷⁸ See, e.g., Dow Jones International News, 'China Pledges Tough Measures to Combat NPLs - Report' (March 19, 1999); and also Harding, James, 'China Banks Sack Managers', *Fin. Times* (March 20, 1999).

¹⁷⁹ See, e.g., Harding, James, 'Official Arrested over Chinese Fraud', and 'China: Corruption May Threaten State', *Fin. Times* (March 5, 1999).

¹⁸⁰ See Kynge, James, 'China: Report Reveals Banking Abuses', *Fin. Times* (December 17, 1999); and also Dow Jones International News, 'China Auditor Uncovers Irregularities at Two State Banks' (December 16, 1999).

E. THE INAPPROPRIATE BANKING REGULATION AND SUPERVISION

External regulation, especially prudential regulation and supervision is critical to ensure the safety and soundness of individual banks and the entire banking system. The failure of the PBOC to develop a prudential supervisory regime has been widely recognized as one of the causes of State commercial banks' NPL problem.¹⁸¹

The PBOC, having engaging in formulating and enforcing the credit plans for such a long time, shifted to the prudential regime just few years ago.¹⁸² Besides, the government's interference in credit allocation not only circumvented the need for thorough risk assessment by the banks, made the government co-responsible for the quality of banks' assets, and provided an implicit government guarantee on banks' liabilities, but also constrained the supervisors in their ability to penalize banks for bad lending decisions. Thus, although bank supervision activities in China dated from May 1985 when the PBOC established its department of bank supervision and examination,¹⁸³ the PBOC had failed to develop prudential supervision on banks until the mid-1990s.¹⁸⁴

F. SUMMARY

To sum up, the empirical analyses support the assumption in the theoretical framework section, *i.e.*, the failure of market discipline is the ultimate cause of the bank NPL problem in China. The state bank-dominated/bank-centric finance, policy loans, administrative controls on banks, weak bank internal controls, and inappropriate banking regulation/supervision have all led to the failure of market discipline. As a result, market discipline do not really work on banks

¹⁸¹ See Wang, Zhaoxing, *supra* note 176, at 18.

¹⁸² As recognized by many Chinese commentators, the prudential regime and the credit plan conflict with each other both in theory and practice. See, *e.g.*, Jin, Weihong, 'An Empirical Study of Debt-Capital Ratio Management as Introduced by China's Specialized Banks', *Guanli Shijie* No. 3, 44, 1996; and Chen Yuan (ed.), *Chinese Financial System Reform*, 31-38 (1994).

¹⁸³ This Department, known as the Examination and Supervision Department, had more than 4,700 personnel by the end of 1988. Among them, however, only about 200 were at the level of senior economist or senior accountant with slightly more than 1,200 in the middle grades. See the World Bank, *supra* note 142, at 33.

¹⁸⁴ Prior to 1995, the PBOC mainly focused on market-entry regulation and supervision. See Wang Zhaoxing, *supra* note 176, at 16.

(especially State commercial banks) and SOEs, budget constraints no longer bite, leading to unsustainable borrowing by SOEs and continuous creation of NPLs on banks' books.

V. THREE BASIC STRATEGIES TO DEAL WITH BANK NPL PROBLEM

In countries where banks are burdened with NPLs, bankers and government officials are grappling with a common problem: how to deal with the vast amount of NPLs so as to produce a healthy banking sector able to survive without State support and contribute to the country's economic recovery. The IMF has examined economic cycles in a range of countries experiencing financial system crises and noted, "turnaround did not occur until decisive actions were taken to deal with the bad loans of the banking system and to wind up insolvent institutions."¹⁸⁵

From the government's point of view, there are three basic policies to deal with banks trapped with NPLs: (1) bank closure and liquidation at large scale, (2) regulatory forbearance, and/or (3) bank restructuring. These policy options are not mutually incompatible and in practice strategies can entail various combinations of each policy. As a matter of fact, in many countries, policy responses to banking problems have often been implemented through a piecemeal process — restructuring part of the banking sector, closing some small banks and postponing the resolution of some troubled banks.¹⁸⁶ In the rest of this section, the advantages and disadvantages of each strategy will be explored so as to discover a suitable policy combination for China.

A. BANK CLOSURE AND LIQUIDATION AT LARGE SCALE

Part of the normal competitive process in any industry is that individual firms should be allowed to fail. Allowing the weakest to fail increases the overall efficiency of the industry; conversely, maintaining overcapacity creates a more difficult environment for the stronger firms. This rationale applies to the banking industry as well.¹⁸⁷ The banking crisis in Russia in the summer

¹⁸⁵ Cited by Richard Jerram in 'Half Measures Hobble Japan's Recovery', *Asian Wall St. J.*, 10 (May 11, 1999).

¹⁸⁶ In Indonesia, for example, there were four major sets of bank closures between November 1997 and March 1999, and several sets of open bank resolution through bank takeovers; the authorities have also sought to address bank insolvency in some cases through recapitalization. To some extent these approaches are complementary, but to some extent also substitutes. See, e.g., Enoch, Charles, *Interventions in Banks During Banking Crises: The Experience of Indonesia*, IMF Policy Discussion Paper (March 2000).

¹⁸⁷ Closure may be cost effective than recapitalization or purchase of problem assets. Moreover, a closure strategy mitigates the moral hazard problems that would arise with any "bail out" of the bank; it may bring about necessary reduction in banking sector capacity, thus improving the viability of the remaining banks; it may enable the

of 1995 illustrates how liquidation of a large number of small institutions can, under certain circumstances, be beneficial to the restoration of confidence in the system.¹⁸⁸

Closure and liquidation at a large scale, however, "is seldom considered a viable option, because of its detrimental effects on the workings of a market economy, because of a potential "domino" effect on other [sound] financial institutions¹⁸⁹ (the very malaise the government is try to avoid), and because of difficulties in judging whether the problems are permanent or merely cyclical or temporary."¹⁹⁰ Moreover, closure and liquidation may disrupt credit relationships between a bank and specific borrowers¹⁹¹ and bear the danger of "credit crunch".¹⁹² In practice, medium-sized or large-sized banks are rarely closed.¹⁹³ In "Asian crisis countries", for example, what the authorities closed were usually small banks,¹⁹⁴ while banks bearing systemic

government to share the costs to the public deriving from banks' insolvency, even in the situation where depositors are protected, by inflicting losses on the banks' shareholders and subordinated debt holders; and it may demonstrate that the government is serious about addressing the banking system's problems. *Id.*

¹⁸⁸ See, e.g., Aslund, Anders, 'When a Banking Crisis Is a Good Thing', *Fin. Times* (13 September 1995).

¹⁸⁹ A bank failure may infect other healthy banks and financial markets more generally. There are several mechanisms of infection. One is through the payments system, where one failure may provoke a chain reaction of non-payment by other participants. Another mechanism of infection is through inter-bank loans. A final mechanism of infection works through the bank deposit market. The danger is that one failure may undermine the public's confidence in banks generally, provoking a generalized bank run. See Hawkins, John & Turner Philip, 'Bank Restructuring in Practice: An Overview' in *Bank Restructuring in Practice*, 6, at 37, BIS Policy Papers No. 6 (August 1999).

¹⁹⁰ See, e.g., Lastra, Rosa Maria, *Central Banking and Banking Regulation*, 141 (1996). Bank closure may be risky: Where the extent of a crisis may not have been fully recognized by the public, the impact of the closures may lead to concerns about the remaining banks, and thus provoke banks runs; closures may disrupt credit or payment flows; and may inflict losses on vulnerable or, conversely, on powerful members of community. See Enoch, Charles, *supra* note 186, at 2.

¹⁹¹ As Lawrence Summers writes: "because of the relationship-specific capital each [lender] has accumulated, reserves at one bank are an imperfect substitute for reserves at another". See Summers, Lawrence, 'Macroeconomic Consequences of Financial Crisis' in Feldstein Martin (ed.), *The Risk of Economic Crisis* (1991).

¹⁹² See Hawkins, John & Turner Philip, *supra* note 189, at 36.

¹⁹³ *Id.*

¹⁹⁴ One of the common strategies shared by "Asian crisis countries" is the immediate closing of insolvent or nearly insolvent financial institutions. This was needed to stem accumulating losses and rapidly growing liquidity support and to give markets a signal that there was a break from the past practice of extensive forbearance. See Balino, Tomas J. T., Enoch Charles *et al.*, *supra* note 59, 'Box 5. Considerations Regarding the Immediate Closure of Banks in a Systemic Crisis' at 31.

The closed banks or non-bank financial institutions were mainly small ones. In Thailand, for example, the 57 finance companies closed only accounted for 11% of the country's financial asset. See the World Bank, *supra* note 79, 'Table 3.5 Structural Changes in the Financial System' at 85.

importance are often kept afloat.¹⁹⁵ Indeed, many countries follow a more-or-less explicit policy of not letting any bank go bankrupt.¹⁹⁶

According to Lardy, banking reform in all transition economies must be based on the rehabilitation of existing banks, entry of new banks, or some combination thereof.¹⁹⁷ While relying primarily on new institutions is a viable strategy in Russia and the other newly independent states, where high inflation so reduced the value of savings deposits that the ratio of deposits to GDP in 1994 was only one-sixth of that in China;¹⁹⁸ relying largely on new institutions in China would inevitably mean the collapse of existing banks, wiping out most of the value of household savings deposits, given China's unusually high ratio of bank deposits to GDP.¹⁹⁹ The importance of State commercial banks in China's financial and economic system means that their closure would imply the disappearance of most intermediation systems.²⁰⁰

B. REGULATORY FORBEARANCE

1. Regulatory Forbearance General

Regulatory forbearance has been applied to deal with banks trapped with NPLs. Regulatory forbearance can be transparent (*i.e.*, an open relaxation of normal regulatory standards) or disguised (*i.e.*, official collusion with banks to conceal the magnitude of the problem).²⁰¹ It may result in lower capital adequacy requirements, more lenient tax treatments, tax breaks, loan loss

¹⁹⁵ In South Korea, for example, the government took over two large commercial banks, Korea First Bank and Seoul Bank, which were technically insolvent in December 1997. Given their systemic importance, the government and the KDIC injected capital, acquiring a stake of about 94% in each bank. See Balino, Tomas J. T., Enoch Charles *et al.*, *supra* note 59, at 121.

¹⁹⁶ A survey of 120 banks in 24 developed countries in the 1980s and 1990s found that two-thirds of failed banks were bailed out, directly or indirectly, by the government. See Goodhart, Charles A, *The Central Bank and the Financial System* (1995).

¹⁹⁷ See Lardy, Nicholas R., *supra* note 17, at 143.

¹⁹⁸ See the World Bank, *From Plan to Market*, 101 (1996).

¹⁹⁹ In 1996, for example, household savings deposits was equivalent to well over one-half of the GDP.

²⁰⁰ See Li, Junjie, 'The Dispatch of Bank NPLs and The Operation of AMCs [yinhang buliang zichan boli he zichan guanli gongshi de yunzhou]', *Modern Commercial Banking [xiandai shangye yinhang]* No. 9, 8, at 8 (September 1999).

²⁰¹ See Hawkins, John & Turner Philip, *supra* note 189, at 19. But Cf. Claessens, Stijin, 'Experiences of Resolution of Banking Crises' in *Strengthening the Banking System in China: Issues and Experience*, BIS Policy Papers No. 7, 275, 'Box 2 Forbearance: Never? If ever, when? And how?' at 283 (October 1999). Where that author divides forbearance into regulatory forbearance (where existing supervisory regulations and standards are waived for an institution), accounting forbearance (where an institution is exempted from following standard accounting practice), and tax forbearance that exempt a class of institutions from paying their full taxes. *Id.* in this volume, all these three kinds of regulatory forbearance is discussed.

reserves and provisioning requirements that are lower than expected losses, and lenient accounting standards and practices.²⁰²

Regulatory forbearance as a tactic to deal with problem banks is based on the assumption that banks would be able to gradually recapitalize themselves through reinvestment of their profits. An obvious advantage of regulatory forbearance as compared with the government recapitalization is that it can save taxpayers' money. The World Bank's 1996 World Development Report, focusing on the problems of transition economies, favors forbearance policies that "promote self-help for banks to encourage them to build up their capital base," allowing banks to "grow out of their bad debt problems."²⁰³

Transparent regulatory forbearance has been widely applied to deal with bank NPL problem. In all "Asian crisis countries", the bank restructuring strategies include tightening of rules for loan provisioning and observance of minimum capital requirements. The tightening of regulations, however, was gradual — but transparent — to give banks times to restructure and mobilize new capital, and to avoid aggravating credit supply problems.²⁰⁴ Regulatory forbearance is not just an issue for developing countries. It has been applied in developed countries as well. During the 1930s depression in the US, banks were allowed to operate even though many were technically insolvent.²⁰⁵ Another example was the lenient regulatory treatment of a number of major money center banks whose loans to heavily indebted countries exceeded their capital in the early 1980s.²⁰⁶

Regulatory forbearance does not always work, however. There are two prerequisites for the successful application of regulatory forbearance. First, the difficulties of banks are due to extreme macroeconomic misalignments or shocks that are likely to be temporary — "Forbearance may be appropriate when an otherwise healthy financial system is subject to an exogenous shock that causes a rapid and unexpected deterioration in the financial condition of its borrowers."²⁰⁷ Second, the banks must be fundamentally sound. Regulatory forbearance may be highly risky when it is applied to institutions that are poorly managed, lack a credit culture, and

²⁰² See Claessens, Stijin, *supra* note 201, 'Box 2, 'Forbearance: Never? If Ever, When? And How?' at 283.

²⁰³ See the World Bank, *supra* note 198, at 103. This view was based in part on the early Hungarian transition experience where "some banks have been recapitalized as many as five times." *Id.*, at 101.

²⁰⁴ See Balino, Tomas J. T., Enoch Charles *et al.*, *supra* note 59, at 49.

²⁰⁵ See Hawkins, John & Turner Philip, *supra* note 189, at 19. In the debt crisis of the 1980s, some international banks were allowed to build up gradually their loan loss provisions against impaired sovereign claims to avoid a severe write-down of their capital.

²⁰⁶ *Id.*

²⁰⁷ See Claessens, Stijin, *supra* note 201, 'Box 2 Forbearance: Never? If ever, when? And how?' at 283.



are engaged in high-risk lending practices.²⁰⁸ Misapplications of regulatory forbearance often result in more expensive bailout later. The experience in the US and Japan shows how harmful the wrongly applied regulatory forbearance could be (see Annex III).

2. Regulatory Forbearance in China: a Failed Policy

Regulatory forbearance has been applied in China as well. The 1995 Commercial Banking Law requires that commercial banks abide by the regulations on asset-liability ratios in their loan businesses, including the 8% CAR requirement.²⁰⁹ The same article of the law, however, provides that a commercial bank established prior to the promulgation of the Commercial Banking Law can take time to conform to the stipulations.²¹⁰ Although the law does require these commercial banks to conform to the ratios within a designated time, the law does not provide the time explicitly but leave that to the State Council.²¹¹ These provisions are in essence disguised regulatory forbearance²¹² and led to worse financial situation of the “big four”. With regard to the percentage of the paid-in capital to the total asset of the “big four”, it was 2.6%, 2.5%, 2.2% and 2.2% in 1994, 1995, 1996, and 1997 respectively,²¹³ showing a clear tendency of deterioration.

The Chinese government recognized the failure of regulatory forbearance. In March 1998, a special treasury bond amounting to RMB270bn was issued to strengthen the capital bases of the “big four”. In 1999, four AMCs were established to take over NPLs from the “big four”. In other words, China turned to bank restructuring strategies.

C. BANK RESTRUCTURING

1. Justification for Bank Restructuring

²⁰⁸ *Id.*

²⁰⁹ The Commercial Banking Law, *supra* note 111, art. 39.

²¹⁰ *Id.*

²¹¹ *Id.*

²¹² China's approach is different from the gradualism of “Asian crisis countries”. The gradualism of “Asian crisis countries”, as discussed above, are transparent, while in China's case, the authorities provide *ad hoc* exemptions and waivers from prudential norms for individual financial institutions in a nontransparent way.

²¹³ See Lardy, Nicholas R., *supra* note 17, Table 3-4 at 93; and Lardy, Nicholas R., *supra* note 4, Diagram 4 at 17-18.

Bank restructuring is justified by the theory of low-level equilibrium in economics. Theoretically, given sufficient time, financial institutions and corporations can overcome their distress as stakeholders resolve their claims on assets, even in the absence of formal bankruptcy procedures, and as restructuring is induced by market pressure. Without additional shocks, the economies would then return to their new long-term sustainable growth path, which could be lower than the pre-crisis time.²¹⁴ This natural recovery, however, takes time and bears at least two risks. First, the continued distress lowers investment, which lowers growth, and in turn further contributes to NPLs and reduces investment and growth prospects. This will happen more probably in a country with a bank-centric financial system. Second, strong incentives exist for all parties to wait rather than to resolve their problems.²¹⁵ International experience suggests that delaying restructuring is costly.²¹⁶

In dealing with the Asian financial crisis, questions have been raised as to whether the economic programs adopted at the time of the crisis should have focused exclusively on macroeconomic policies, leaving the structural reform for a later time, or whether the structural reforms should have been made at a slower pace. Several considerations regarding the financial sector argue against delay: (1) A banking system saddled with large amounts of NPLs would have maintained an excessively cautious lending policy, which would have caused an uneven greater credit slowdown and further delayed the restoration of normal credit flows. (2) In cases where banks (and companies) were insolvent, allowing them to continue operating without restructuring would have allowed market distortions and moral hazards to build. (3) Bank and corporate restructuring was necessary to facilitate the rollover of maturing foreign loans and new private investment that were crucial to ensure the necessary financing of economies. (4) Keeping insolvent banks (and companies) in operation could have entailed higher fiscal costs and a further complicated monetary management.²¹⁷

Interestingly, the same questions have been raised in China as well. According to some observers, restructuring Chinese banks before the underlying causes of the accumulation of bad loans are removed would be useless. In their view, restructuring SOEs — that is, reforming these firms and imposing upon them hard budget constraints — should be the first step. This, in turn,

²¹⁴ See the World Bank, *Global Economic Prospects and the Developing Countries 1998/1999: Beyond Financial Crises* (1999).

²¹⁵ See the World Bank, *supra* note 79, 'Box 3.1 Why Distress Can Persist' at 80.

²¹⁶ *Id.*, at 84.

²¹⁷ See Balino, Tomas J. T., Enoch Charles *et al.*, *supra* note 59, at 25.

would require discharging SOEs from the responsibility for providing a broad range of social services, shifting such costs directly to the budget: the accompanying increase in public expenditure should be matched by a corresponding increase in tax revenues. At the present time, when the growth of the Chinese economy has slowed and public confidence in the economy, for a variety of reasons, is low, it is definitely not the right time for hastening real reform of the SOEs, and hence there should be no rush to undertake a radical reform of the Chinese financial sector.²¹⁸ While obviously “correct”, this should not be used as an excuse for doing nothing until an unlikely ‘big bang’ turns the Chinese economy around.

2. Ten Critical Points in Managing and Resolving a Systemic Bank Crisis and Their Implication for China

The IMF summarized ten critical steps in managing and resolving a systemic bank crisis.²¹⁹ According to the IMF, although specific actions may differ among countries based on the depth of the crisis, the composition of the financial sector before the crisis, local circumstances and preferences, the contents and sequence of the basic building blocs and strategies should be similar across countries.²²⁰ The 10 steps are divided in three phases as follows.

Steps 1-4 — The Acute Crisis Phase. In this phase, measures should be taken to stop the panic and stabilize the system. This phase comprises four steps: (1) The crisis usually begins because, in one form or another, there is excessive leverage in the economy. In the early stages there may also be a degree of denial on the part of banks and the government. (2) Bank runs by creditors and depositors start and intensify. The central bank responds by providing liquidity supports to the affected banks. (3) When central bank liquidity is unable to stop the runs, the government announces a blanket guarantee for depositors and creditors. Such a measure is intended to reduce uncertainty and allow time for the government to begin an orderly

²¹⁸ See Lau, Lawrence J., ‘The Macroeconomy and Reform of the Banking Sector in China’ in *Strengthening the Banking System in China: Issues and Experience*, BIS Policy Papers No. 7, 59, at 84 (October 1999).

That author, after analyzing the fiscal situation of China, concluded that the Chinese economy is not in imminent danger of financial collapse, despite the existence of a significant stock of NPLs. The system is sustainable for at least another decade or longer. *Id.*, at 80-85.

²¹⁹ See Balino, Tomas J. T., Enoch Charles *et al.*, *supra* note 59, at 10. The sequence is based on the assumption that a country’s financial sector has public good aspect, and, hence, that solving such a crisis warrants substantial public sector involvement. *Id.*

²²⁰ *Id.*

restructuring process. (4) All along, the central bank tries to sterilize its liquidity support to avoid a loss of monetary control.

Steps 5-8 — The Stabilization Phase. In this phase, measures should be taken to restructure the system. This phase usually consists of the following four steps: (5) The authorities design the tools needed for a comprehensive restructuring, including the required legal, financial and institutional framework. (6) Losses in individual institutions are recognized. The authorities shift the focus from liquidity support to solvency support. (7) The authorities design a financial sector restructuring strategy, based on a vision for the post-crisis structure of the sector. (8) Viable banks are re-capitalized, bad assets are dealt with, and prudential supervision and regulations are tightened.

Steps 9-10 — The Recovery Phase. In this phase, measures are taken to normalize the system. This phase consists of two steps: (9) Nationalized banks are re-privatized, corporate debt is restructured, and bad assets are sold. (10) The blanket guarantee is revoked which, if properly handled, is a nonevent because the banking system has been re-capitalized and is healthy again.

What stays in the core of these ten steps is that for a country facing systemic bank problem — evidenced by a banking system burdened with NPLs and an inefficient corporate sector, the authority must tackle simultaneously bank and enterprise restructuring and dealt decisively with the NPL stock²²¹ and flow²²² problem, with measures to improve incentives and institutional skills — *i.e.*, to promote better internal controls in banks and to enhance banking regulation and supervision.²²³ In other words, a comprehensive bank restructuring contains at least the following components: (1) bank recapitalization, (2) NPL management, (3) enhancement of banking regulation and supervision, (4) promotion of banking internal controls (especially risk-management capacity).

D. SUMMARY

²²¹ To deal with the “stock” problem is to deal with the banks’ current balance sheets, raising capital and removing NPLs.

²²² To deal with the “flow” problem is to improve the quality of banks’ earnings so banks’ balance sheets do not quickly deteriorate again.

²²³ This strategy is recommended by Chinese Scholars as well. See, *e.g.*, Task Team of Xiamen University, ‘Credit Assets, Risk of State-Owned Commercial Bank: The Prevention of Their Increase and the Dissolution of Their Stock [guoyou shangye yinghang xingdai zichan fengxian: Zhenliang fangfan yu chunliang huajie]’, *Economic Research Journal* No. 5, 18 (May 1999).

To sum up, the accumulation of NPLs is not a problem unique to China. Governments all over the world have been tackling this problem. In this course, three strategies have been developed, namely, bank closure and liquidation at large scale, regulatory forbearance, and bank restructuring. While these policy options are not mutually incompatible and in practice strategies can entail various combinations of each policy, each government will have to make its choice when it is faced with bank NPL problem.

China cannot afford to close and liquidate its State commercial banks. Given their importance in China's financial and economic system, their closure would imply the disappearance of most intermediation systems and damage the economic growth. Regulatory forbearance, despite its advantages of cost-saving (the American and Japanese experience shows that regulatory forbearance usually results in more fiscal burdens to solve the problem eventually), is not suitable for China, too. The two pre-conditions for the successful application of regulatory forbearance — temporary economic difficulty, fundamental soundness of the banking system — do not exist in China. A comprehensive bank restructuring seems a possible solution to the NPL problem in China.

VI. CONCLUSION

China's bank NPL problem is not limited to individual banks; rather, it is pervasive in all State commercial banks. NPLs not only have negative effects on State commercial banks, but also on the country's economic reform and its real economic growth. And, because the amount of NPLs is so huge, the "big four" have been technically insolvent for several years. Given their weightiness in the whole financial system, the NPL problem with State commercial banks is threatening the stability of the whole financial system, and even the whole economy. It is therefore necessary to tackle the problem immediately.

The causes of NPL problem are systemic. The state bank-dominated financial system, the bank-centric finance, the soft credit to SOEs in the form of policy loans, the administrative controls on banks, and weak internal controls in banks and inappropriate prudential supervision on banks have led to the deterioration of market discipline in China and consequently result in the accumulation of NPLs on State commercial banks' books. In other words, China's bank NPL

problem is actually a reflection of weakness in its financial and corporate sector and need a systematic solution.

Several points can be made here. First, problems with banks and SOEs are so interwoven that they can only be solved together. Second, the seriousness of NPL problem with state banks is not limited to the massive existing NPLs on the banks' books, but also the creation of new NPLs. Endeavors therefore must be taken to control the creation of new NPLs. To achieve this, State commercial banks must be freed from making policy loans, unnecessary administrative controls on State banks must be removed, prudential regulation and supervision must be strengthened, and efforts must be made to promote bank internal controls in China. Last but not least, the lack of market discipline underpins the macro and micro reasons for the accumulation of, and the increase in bank NPLs in China. Without the restoration of market discipline, the NPL problem cannot be really solved. It is therefore important to design the NPL workout and prevention procedures in consistent with market discipline rather than suppressing market discipline.

I. INTRODUCTION

The bank NPL problem must be solved immediately in China. To achieve this, China will have to implement a comprehensive bank restructuring — to carry out simultaneously bank and enterprise restructuring and deal decisively with the NPL stock¹ and flow² problem, with measures to improve incentives and institutional skills. This chapter will cover issues related to NPL workouts, namely, bank recapitalization, setting up AMCs to take over NPLs from the “big four”, and NPL management (mainly debt-equity swaps).

The rest of the chapter comprises six sections. Issues related to bank recapitalization are discussed in Section II. Section III focus on AMC theories and practices. Two basic NPL management strategies — asset management strategy and loan management strategy — are to be discussed in Section IV, with a loan management strategy recommended for AMCs in China. Section V focuses on the on-going debt-equity swaps in China. A legal infrastructure for debt disposal and restructuring is explored in Section VI. Section VII summarizes the discussion in this Chapter.

II. RECAPITALIZING THE “BIG FOUR”

¹ To deal with the “stock” problem is to deal with the banks’ current balance sheets, raising capital and removing NPLs.

² To deal with the “flow” problem is to improve the quality of banks’ earnings so that banks’ balance sheets do not quickly deteriorate again.

The erosion in bank capital is the logical development of the accumulation of NPLs.³ This is exactly the case in China, where banks' capital base has been deteriorating sharply in the reform era.⁴

Recapitalization is the core of any bank rehabilitation strategy. Banks must have sufficient capital before they can provision for and write off NPLs. Furthermore, bank recapitalization is essential to the economic recovery, as evidenced in the Asian financial crisis.⁵

A. JUSTIFICATION FOR GOVERNMENT RECAPITALIZATION OF THE "BIG FOUR"

1. State Ownership of the "Big Four"

Andrew Sheng, when conducting studies on bank restructuring in the 1980s, argued that in general the burden of recapitalizing banks should be borne, in descending order, by borrowers, private bank shareholders, bank employees, the government, and depositors; and that depositors should be protected against losses due to bank failures.⁶ In China, because the "big four" are entirely State-owned and most of their borrowers are SOEs owned by the government, to have the borrowers or the shareholders bear the losses is the same as to have the government bear the losses. Selling shares of the "big four" to the public, assuming it were a practical option, results in the dilution of government ownership and allocates the losses to the government indirectly. Since the losses would have to be borne by the government, a direct government capital injection might be a rational choice.

³ E.g., in South Korea, after the sharp increase between December 1996 and September 1997 of the share of NPLs in total assets of commercial banks, the net worth of many financial institutions fell perilously low, and a significant shortfall in capital adequacy emerged. Of the 26 commercial banks, 14 had CARs below 8%, of which two were deemed to be technically insolvent (with zero or negative capital). In addition, 28 of the 30 merchant banks had CARs below 8% and 12 were deemed technically insolvent. See Balino, Tomas J. T., Enoch Charles *et al.*, *Financial Sector Crisis and Restructuring Lessons from Asia*, 116-7 (the IMF, September 1999).

⁴ See Lardy, Nicholas R., *infra* note 28, table 3-4 at 93; and Lardy, Nicholas R., *infra* note 48, Diagram 4 at 17-18. As reflected in the table and the diagram, relative to their assets, the paid-in capital of the "big four" fell by five-sixths, from 12.1% in 1985 to 2.2% at year-end 1997.

⁵ From the point of view of the economic health of a country, it is essential that those potentially viable businesses are re-financed and that the banks are able to start lending again. During the Asian financial crisis, however, because banks saddled with massive NPLs were unable to extend credit, although there were still a large number of potentially viable export-focused businesses throughout Asia, they were constrained by a lack of cash flow and trade finance. See Earnest & Young International, *Asia Pacific Economic Outlook: 1999-2009*, 9 (1999).

2. The Low Profitability of the “Big Four” Denotes That They Cannot Grow out of the Problem Themselves

As part of the strategy formally adopted by the State Council in 1993 of converting specialized banks to commercial banks, the PBOC in 1994 notified banks that they would have to comply with the capital adequacy standards set by the Basle Capital Accord.⁷ This commitment was reaffirmed in the 1995 Commercial Banking Law.⁸ Initially, the government wished that the “big four” could come into compliance with the 8% capital adequacy standard by the end of 1996, largely through the growth of retained earnings and increasing provisions for NPLs.⁹ This proved an unrealistic goal. The low profitability of the “big four” denotes that they cannot grow out of the problem themselves.

The profitability of the “big four” declined sharply in the early 1990s and shows no indication of reversing. From 1994 to 1996, the return on assets of the “big four” stood at only 0.3%.¹⁰ This simply reflects the fact that while loans (the principal asset of banks) expanded rapidly, profits grew much more slowly. The declining profitability indicates that banks will not be able to climb to the 8% capital adequacy standard merely through the growth of retained earnings and increased provisions for NPLs.¹¹

3. Difficulties for the “Big Four” to Raise Capital

As an established policy in “Asian crisis countries”, banks must raise private capital themselves before they would be qualified for government capital injection. In Indonesia, for example, bank owners had to provide 20% of the capital shortfall before they could turn to the government for the remaining 80%. In South Korea, after June 30, 1998, public resources

⁶ See, e.g., Sheng, Andrew, *Bank Restructuring: Lessons from the 1980s*, 32 (1996).

⁷ See Provisional Measures On Commercial Banks' Asset: Liability Ratio Management, issued by the PBOC on February 18, 1994.

⁸ The Law of the People's Republic of China on Commercial Banks, adopted at the 13th Session of the Standing Committee of the 8th National People's Congress on May 10, 1995, and effective as of July 1, 1995 (hereinafter referred to as “the Commercial Banking Law”), art. 39.

⁹ See Jiang, Zuqi, ‘The Progress and Future of China's State Specialized Banks' Commercialization Reform’, *Guoji Jinrong Yan Jiu* No. 1, 8 (January 1996).

¹⁰ See Lardy, Nicholas R., *infra* note 28, table 3-8 at 100; and Lardy, Nicholas R., *infra* note 48, at 23.

¹¹ Theoretically, there is a way to achieve this, i.e., the banks cut their lending to the real economy. This will lead to credit crunch on enterprises and sacrifice the economic growth.

— through subscription of capital instruments and NPL purchases — could only be committed on the condition that adequate contributions be made by shareholders and other stakeholders.¹² The Thai government only matched the amount of capital injected by private investors under its tier-1 capital support scheme.¹³ The idea behind the policy is to minimize the moral hazards accompanying the public capital injection.

Should China follow this model? There have been strong arguments for diversifying the ownership structure of the “big four”.¹⁴ The current author, however, doubts whether it is the right time for the Chinese government to sell stakes in the “big four”. Private investment in State banks cannot be taken as granted. Government guarantees are behind almost all the deals in “Asian crisis countries”.¹⁵ The Chinese government must improve the asset quality of the “big four” before diversifying their ownership.¹⁶

B. RECAPITALIZING THE “BIG FOUR” — TECHNICAL CONSIDERATIONS

1. Liability Side Vs. Asset Side Recapitalization

Technically, there are different ways of helping banks in distress (see Annex IV). Bank recapitalization can affect both the asset and liability side of a bank’s balance sheet.

¹² See Balino, Tomas J. T., Enoch Charles *et al.*, *supra* note 3, at 118.

¹³ *Id.*, ‘Box 5. Thailand: Capital Support Facilities’ at 164.

¹⁴ See Zhao, Haikuan, ‘The State Commercial Banks Should Be Converted into Joint Stock Banks [guoyou shangye yinhang yiyu shixing gufengzhi]’, *China Finance (Beijing)* No. 11, 26, at 26 (November 1999).

¹⁵ This was fully evidenced in two of the deals carried out by the Bank of Thailand. In the Nakornthon deal, Bt36bn in bad loans, accounting for approximately 65% of the Nakornthon’s total lending, was 100% guaranteed by the Thai government. The government had also provided a guarantee for 85% of the eventual losses on the remaining portion of the NPLs, and similar protection for 15% of the performing loans as well. The government was also obliged to pay Standard Chartered twice a year for the cost of carrying the NPLs, under a yield maintenance scheme. Standard Chartered would also not be required to make provisions for the bad debt that is guaranteed by the government, which should avoid the need for an additional capital injection over the next few years. See generally Bardacke, ‘Nakornthon: Standard Chartered Gets Free Reign’, *Fin. Times* (September 14, 1999).

The structure of the Randanasin deal was similar to that of the Nokornthon. The principal difference is that while the Bank of Thailand offered similar guarantees on NPL losses, in the Randanasin case they were placed in an AMC. The bank’s high proportion of problem loans - about \$1bn or 80% of the book - were to be injected into an asset-management corporation to be owned by the Bank of Thailand but run by UOB. The central bank made a preliminary agreement to cover 85% of the AMC’s losses and take 95% of whatever profits would be squeezed out of it. See Barners, William, ‘UBO: Thai Bank Taken on Despite Bad Debts’, *Fin. Times* (October 7, 1999).

¹⁶ This has been realized by Chinese policy-makers. Dai, Xianglong set out a roadmap for reforming the “big four” at a PBOC press conference on January 19, 2000. He said that the State banks had to slash their payrolls,

On the asset side the main solution entails a transfer of government securities. This can be un-required, but more often securities are swapped for NPLs.

Un-required injections of cash or bonds (negotiable or non-negotiable) will immediately increase a bank's net worth, improve its capital ratios, liquidity, and potential profitability.¹⁷ The main drawback of un-required cash or bond injection is, of course, that the government does not have any increased ownership or control rights.¹⁸

Swapping impaired assets for cash or bond will usually be at market prices (less, possibly substantially less, than book value). Even so, these swaps will improve the bank's capital adequacy, liquidity, the ability to make loans, and can reduce funding costs. Risk-weighted capital ratios improve because the swap, generally, replaces risky loans with low-risk investments, such as government bonds or cash.¹⁹

On the liabilities side recapitalization can occur through the purchase of new bank shares, the granting of long-term subordinated loans, or the assumption of bank liabilities. Equity purchase or subordinated loan granting by the government can immediately increase a bank's net worth, improve its capital ratios, liquidity, and potential profitability. Liability assumption by the government facilitates banks to re-negotiate their debts and obtain breathing space. Debt renegotiation can sometimes even result in banks' liability reduction, which improves banks' capital adequacy and potential profitability.²⁰

Authorities in China must find a suitable way to recapitalize the "big four". Given the high NPL level of the banks, swapping impaired assets for cash or bond might be a good choice.

2. Cash Injection Vs. Bond-Bad Debt Swap

Issuing bonds to banks is a common practice for countries whose financial resources do not allow them to recapitalize their banks in cash. According to the IMF, bonds issued by the governments of Indonesia, Korea, and Thailand are the main instruments for financing the

clear out bad loans and exercise strict "credit discipline" before they could be transformed into "shareholding" companies. See Kynge, James, 'China to Speed up Financial Reforms', *Fin. Times* (January 21, 2000).

¹⁷ See Claessens, Stijin, 'Experiences of Resolution of Banking Crises' in *Strengthening the Banking System in China: Issues and Experience*, BIS Policy Papers No. 7, 275, 'Box 4 Different Kinds of Support to Banks' at 289 (October 1999).

¹⁸ *Id.*

¹⁹ *Id.*

governments' contribution to the restructuring costs.²¹ In Poland, the 1993 recapitalization of the seven State banks was carried out by providing the seven banks with PZL11trillion in fifteen-year treasury bonds.²²

Given China's fiscal situation, it is clear that the government will not be able to finance the recapitalization of banks from its current tax revenues. The real GDP growth rate of China has been declining yearly since 1995.²³ Making matters worse, government revenues as a share of GDP fell from 35% in 1978 to 11% in 1996, and the tax revenues from 14% to 10%.²⁴ These revenue levels are much lower than those of other countries.²⁵ Total government debt at the end of 1998 was about RMB1,688bn, or 20.5% of GDP.²⁶ This was almost five times the level of five years before.²⁷ It will be unrealistic to expect a government in such a difficult fiscal situation to finance the bank recapitalization with current revenues.

Therefore, China's best option is probably to follow the course pursued by the Eastern European and Asian countries, injecting government bonds in an amount equal to the value of the NPLs being written off, *i.e.*, a bond-bad debt swap. Since the bonds would pay interest, an injection of bonds would provide the banks with income-earning assets. Moreover, over a period of time the bonds could be sold on the secondary market, making the value of the injection quite transparent. Thus the injection of bonds would give the banks a measurable asset and an obvious source of income that could be used to pay interest to household savers. As a result the likelihood of a loss of public confidence and resulting run on the banks would

²⁰ *Id.*

²¹ In Indonesia, variable and fixed coupon bonds are issued to banks in exchange of equity, variable and tradable bonds are issued to banks in exchange for NPLs, and index-linked tradable bonds are issued for debt-to-equity conversions. In South Korea, tradable variable coupon bonds are issued to banks in exchange for equity or preferred shares. In Thailand, tradable fixed-coupon bonds are issued to banks for equity in banks, non-tradable fixed-coupon bonds are issued to banks in exchange for subordinated debt. See Balino, Tomas J. T., Enoch Charles *et al.*, *supra* note 3, 'Table 12. Instruments Used to Recapitalize and Purchase NPLs' at 61.

²² See Gray, Cheryl W. & Holle, Arnold, *Bank-Led Restructuring in Poland (I): An Empirical Look at the Bank Conciliation Process*, 5 & note 20 (the World Bank, September 1996).

²³ The real GDP growth rate was 10.5%, 9.6%, 8.8%, and 7.8% for 1995, 1996, 1997 and 1998 respectively.

²⁴ See Stiglitz, Joseph E., 'Second-Generation Strategies for Reform for China (zhongguo dierbu gaige zhanlue)', *People's Daily (Overseas Edition)*, 2 & 3 (November 13, 1998).

²⁵ The average for all developing countries was 31.7%. See the World Bank, *The Chinese Economy: Fighting Inflation, Deepening Reform*, 39, A World Bank Country Study (1996).

²⁶ China's total debt issued and annual interest payments plus repayment of principle reached 34% and 24% of the fiscal revenue, respectively in 1997 and 1998. See Choy, Gilbert C., 'Keynes Fails in China . . .', *Asian Wall St. J.*, 10 (December 16, 1999).

²⁷ See Kynge, James, 'China: A Fraught Fiscal Future', *Fin. Times* (January 11, 2000). This sum is thought to have included RMB803bn in Treasury debt; an issue of RMB270bn for a partial recapitalization of the "big four"; interest payments on the RMB803bn of Treasury bonds; and RMB532.2bn of bonds issued by the State Development Bank. *Id.*

be reduced significantly.²⁸ Moreover, tradable bonds help the banks manage their liquidity, as they can sell the bonds if liquidity is needed.

3. *Ex-ante* Recapitalization Vs. *Ex-post* Recapitalization²⁹

Ex ante recapitalization and *ex post* recapitalization denotes whether to recapitalize banks before, or after corporate restructuring. Under an *ex ante* recapitalization, with appropriate burden sharing, the government recapitalizes banks based upon an assessment of probable losses (determined by outside audits and independent portfolio reviews). Some loans may be transferred, at the time of recapitalization or afterwards, to AMCs. The banks are left to deal with the major part of the NPLs themselves. Poland carried out this *ex ante* recapitalization, with a one-time recapitalization of the banks, designed to be large enough to ensure adequate capital and make credible the “one-time-only” promise. The amount of each bank’s recapitalization was based on the value of its portfolio of bad debts at year-end 1991, as identified in audits conducted in 1992 by international accounting firms.³⁰ After the recapitalization, a bank-led debt restructuring was carried out in Poland.³¹

Ex ante recapitalization can be fast and signal to the market that problems are being resolved. It also formalizes government guarantees of bank liabilities. And, provided that it is accompanied by substantive improvements in corporate governance and bank operations and well monitored, it can be an up-front investment that leads to lower ultimate costs. But *ex ante* recapitalization has also carried great risks. First, it will be hard to assess probable losses in countries lacking accounting practices, while it is important for the government to inject sufficient money into banks to avoid further bailout. Second, in most cases, governments routinely respond to such systemic bank solvency problems by injecting capital into insolvent banks, without change in bank governance and operations, resulting in the waste of the recapitalization. Third, although banks will definitely have better capacity to work out loans and take losses when recapitalized, they may still delay restructuring and roll over NPLs

²⁸ See Lardy, Nicholas R., *China’s Unfinished Economic Revolution*, 157 (1998).

²⁹ The discussion in this part relies heavily on Claessens, Stijin, *supra* note 17, at 293-4.

³⁰ The first set of audits by international auditing firms were carried out for all nine State banks in the summer of 1991. The audits were repeated in mid-summer 1992 and (for the seven banks still in the State hands) again in 1994. The recapitalization was based on the status of loan portfolio as of end-1991, as measured in the 1992 audit. See Gray, Cheryl W. & Holle, Arnold, *supra* note 22.

³¹ See Annex VI.

since they are able to attract new funds anyhow.³² And, likewise, corporations may have little incentive to undertake necessary operational restructuring, if they have access to new funds anyway.

These risks are very real for a country like China without advanced accounting rules and lacking an appropriate legal infrastructure for debt disposal and restructuring. Besides, banks in China do not have sufficient skills and techniques to restructure their corporate borrowers. The failed RMB270bn recapitalization of the “big four” in 1998 evidences the failure of *ex ante* recapitalization in China.

In contrast to *ex ante* recapitalization, *ex post* recapitalization denotes that banks receive public funds as, and when they provide financial relief to corporations. This model provides more time to undertake the necessary fundamental reforms and maintains pressures on banks and corporations to agree quickly on realistic financial and operational restructuring. The main drawback is uncertainty, as depositors and other creditors can be uncertain about the quality of their claims.

In between *ex ante* and *ex post* recapitalization, the government may choose to set up AMC's to take over NPLs from banks, so that banks are recapitalized by the consideration paid by the AMC's for the NPLs. The AMC's, rather than the banks will be in charge of corporate debt restructuring. As will be shown below, China actually is carrying on this in-between model to recapitalize the “big four”.

4. Central Bank Vs. Treasury

Theoretically, the cost of bank recapitalization could be borne by either the central bank³³ or the treasury. This author, however, would argue that the Ministry of Finance (MOF) in China should bear the cost of recapitalizing the “big four”, based on the following two reasons.

First, as indicated in Chapter One, the “big four” are insolvent, but not illiquid. International experience shows that bank insolvency cannot be solved by protracted liquidity

³² Banks in Japan, for example, have shown no inclination to undertake corporate restructuring, as they can continue to carry NPLs at low costs. See Claessens, Stijin, *supra* note 17, at 294.

³³ Examples include the National Bank of Poland's purchase of shares and low-yield long-term bank bonds from Polish banks. In Indonesia, some central bank liquidity support is at present being converted into government equity in the recipient banks. See, e.g., Hawkins, John & Turner Philip, ‘Bank Restructuring in Practice: An Overview’ in *Bank Restructuring in Practice*, 6, at 53, BIS Policy Papers No. 6 (August 1999).

support from the central bank. “At the root of a successful program lies the recognition that systemic banking crises are a fiscal, not a monetary problem.”³⁴

Second, to recapitalize a commercial banking system by a reduction in the net worth of the central bank is only possible when a country’s central bank has high levels of capital, primarily non-interest-bearing monetary liabilities, and significant foreign exchange reserves. When this is not the case, the cost of injecting fresh capital into the banking system must be borne by the treasury.³⁵

The ability of the PBOC to absorb the losses of the “big four” is limited by its own financial weakness, as reflected in both the asset and liability sides of its balance sheet. Unlike most central banks in the world,³⁶ the principal assets of the PBOC are not government bonds, but loans to financial institutions (including the “big four”). From the mid-1980s through 1993 these loans on average constituted more than three-quarters of the PBOC’s assets. At year-end 1996, the central bank’s loans to financial institutions stood at RMB1.5 trillion, which was equal to just over half of its assets.³⁷ Since the ultimate borrowers of the PBOC loans to other financial institutions are loss-making SOEs, which too frequently are unable to repay the loans, there are risks that the PBOC will have to write off a substantial part of its loans to financial institutions.

The liability side of the PBOC balance sheet also compares unfavorably with most other central banks. The largest liability of central banks traditionally is currency issued. Holders of currency receive no interest, making this an ideal liability for central banks. But the single largest liability of the PBOC, accounting for over one-half of total liabilities, is the required and excess reserves placed by banks with the central bank. The PBOC pays interest on all of these reserves.³⁸

³⁴ See Dornbusch, Rudi & Giavazzi, Francesco, ‘Heading off China’s Financial Crisis’ in *Strengthening the Banking System in China: Issues and Experience*, BIS Policy Papers No. 7, 40, at 47 (October 1999).

³⁵ See Sheng, Andrew, *supra* note 6, at 34.

³⁶ The principal asset of most central banks is government bond. These pay a fixed rate of interest and are backed by the full faith and credit of the central government.

³⁷ See the PBOC, *China Financial Outlook '97*, 95 (1997).

³⁸ The reserve requirement was first introduced in 1984, with the reserve ratio ranging from 20-40% for different types of deposits. In 1985, this range was replaced by a uniform ratio of 10%, which was raised to 12% in 1987 in order to curb inflation. Since 1988, it has been fixed at 13%. An overhaul of the deposit reserve system was conducted in March 1998. Different reserve and deposit requirements were unified by a single reserve requirement, with the ratio reduced to 8%. It was further lowered to 6% from November 21, 1999 on in a move to spur economic growth through increased bank lending. The required reserve was interest bearing. See Chai, Joseph C. H., *China: Transition to A Market Economy*, 131 (1997); Dai, Gengyou, ‘A

The financial weakness of the PBOC determines that the cost of injecting fresh capital into the large banks should be born by the MOF rather than the PBOC.

5. Summary

Issues related to the recapitalization of the “big four” are considered in this section. It is suggested that the “big four” be recapitalized by swapping impaired assets for bonds. Bond-bad debt swap is recommended because of China’s poor fiscal situation. The timing of the recapitalization is also considered. It is argued that China should not choose to recapitalize the “big four” once-for-all — *ex ante* recapitalization. The last issue considered is who should bear the cost of recapitalizing the “big four”. It is argued that the MOF rather than the PBOC should bear the recapitalization cost.

C. COMMENTS ON CHINA’S BANK RECAPITALIZATION PRACTICES

1. The Special Treasury Bond Issuance in 1998

In March 1998, the 9th NPC examined and passed a resolution allowing the MOF to issue special bonds totaling RMB270bn to replenish the capital of the “big four”.³⁹ This recapitalization was implemented in three steps in conjunction with the reduction in the deposit reserve requirement: (1) The PBOC lowered the legal reserve requirement from 13% to 8%,⁴⁰ freeing up about Rmb377bn of bank liquidity.⁴¹ (2) In August 1998, the MOF issued RMB270bn 30-year bonds to the “big four”, with an annual coupon rate of 7.2%.⁴² The “big

Review of PBOC’s Monetary and Credit Policy’, *China Finance (Beijing)* No. 12, 27 (1998); and also Chinaonline, ‘China Central Bank Cuts Reserve Ratio to Spur Growth’ (November 19, 1999).

³⁹ See, e.g., Chinaonline, ‘China’s Central Bank Governor on Financial Situation’ (March 7, 1998), available at ‘http://www.chinaonline.com/industry/fina.../News_Archive/Secure/1998/May/fn_002.asp’. The NPC authorized the MOF to decide the term and interest rate of the bonds. *Id.*

⁴⁰ See, e.g., Xie, Ping, ‘Bank Restructuring in China’ in *Bank Restructuring in Practices*, 124, at 124-5, BIS Policy Papers No.6 (August 1999).

⁴¹ Roughly RMB270bn from the State-owned banks and RMB107bn from other financial institutions. The PBOC recalled part of its loans to the State-owned banks to offset the inflationary impact of the reduction in the reserve requirements. See, e.g., Mo YK, ‘A Review of Recent Banking Reforms in China’ in *Strengthening the Banking System in China: Issues and Experience*, BIS Policy Papers No. 7, 90, at 93 (October 1999).

⁴² See, e.g., Lau, Lawrence J., ‘The Macroeconomy and Reform of the Banking Sector in China’ in *Strengthening the Banking System in China: Issues and Experience*, BIS Policy Papers No. 7, 59, at 73 (October 1999).

four” purchased the bonds with funds freed up by the lowering of the required reserve ratio. (3) The MOF injected the entire proceeds into the State-owned banks to strengthen their equity capital.⁴³

The recapitalization plan raised the capital of the “big four” to RMB478bn from RMB208bn. After the capital injection, the size of the aggregate balance sheet of the State-owned banks remained unchanged. The balance sheet of the PBOC contracted but this was offset by a similar expansion in the balance sheet of the MOF.⁴⁴ The recapitalization plan not only strengthened the capital of the “big four” but also had positive implications for their future income streams:⁴⁵ First, the “big four” could benefit from the yields arising from investment in the bonds. This amounted to RMB19.4bn a year before additional dividend payments to the MOF because of the government’s increase in equity holdings. Second, in paying off some central bank credits, the “big four” could also reduce their interest costs.⁴⁶

It was expected then that after the RMB270bn injection, the risk-weighted capital adequacy of the “big four” could have reached the 8% standard set by the Basle Capital Accord and the Commercial Banking Law.⁴⁷ The expectation proved unrealistic, however. According to Lardy, this recapitalization scheme was neither well timed nor in the right size.⁴⁸

With regard to the timing, Lardy’s main criticism is that the recapitalization was timed such that it fostered the expectation that having bailed out troubled banks once, the government would do so again: Although there was some evidence, particularly after mid-1993, that banks were beginning to curtail the flow of new lending to money-losing SOEs,⁴⁹

⁴³ See, e.g., Mo YK, *supra* note 41, at 93.

⁴⁴ For details of the changes in the aggregate balance sheet of the State-owned banks, the balance sheet of the PBOC, see Mo YK, *supra* note 41, at 106-108.

⁴⁵ *Id.*, at 94.

⁴⁶ YK MO of the BIS Hong Kong Office did a calculation and estimated that the reduction in interest cost could amount to RMB4-5bn a year. This, totaled with the yields from the bonds, would mean RMB23-24bn increase in the big four’s profits annually, almost as much as their aggregate profits in 1997. *Id.*

⁴⁷ See Xinhua News Agency, ‘The Ministry of Finance is to Issue Special Treasury Bonds Worth RMB270 to Enhance the Capital of State Owned Commercial Banks (*Buchong Guoyou duzi Shangye Yinghang Zibenjing, Caizhengbu Faxing 2700yi Tebie Guozhai*)’, *People’s Daily (Overseas Edition)*, 1 (March 2, 1998).

In June 1997, the CAR of the big four was 5.86%. After deduction of NPLs, the rate was as low as 3.5%. That urged the RMB270bn capital injection. See Chinaonline, ‘State-Owned Commercial Banks to Offer Long-term Financial Bonds’ (March 14, 2001), available at <http://www.chinaonline.com/topstories/010314/1/C01031302.asp>.

⁴⁸ See Lardy, Nicholas R., ‘The Challenge of Bank Restructuring in China’ in *Strengthening the Banking System in China: Issues and Experience*, BIS Policy Papers No. 7, 32-3 (October 1999).

⁴⁹ This policy was reinforced in the spring of 1998 when the NPC endorsed the goal of encouraging commercial behavior on the part of State-owned banks.

by mid-1998 this policy appeared to have been significantly modified when the PBOC directed these banks to continue to extend additional loans to money-losing SOEs.⁵⁰ Shortly thereafter, the government completed the RMB270bn injection of capital into the “big four”. Requiring banks to lend additional funds to firms that have only limited prospects of amortizing their loans created the expectation on the part of banks that additional recapitalization funds would inevitably be forthcoming. That expectation seriously undermined the prospect for a fundamental change in bank lending behavior.

Compared to huge amount of NPLs accumulated on the four banks’ balance sheets, estimated to be RMB1trillion,⁵¹ the RMB270bn recapitalization of the “big four” undertaken in August 1998 fell far short of the recapitalization amount that they would ultimately require.⁵²

To guarantee a successful *ex ante* recapitalization, China would have had to follow the Polish approach and to have internationally recognized accounting firms audit the financial situation of the “big four” before deciding the size of the recapitalization. This proves unrealistic at least at this moment, however, because China cannot afford the risk of losing the public confidence in the “big four”.⁵³ Besides, even if an exact amount of recapitalization can be determined, whether the government can afford it once-for-all remains doubtful.

⁵⁰ Notice Concerning Further supporting State-Owned Industrial Enterprises that Are Losing Money which Have Salable and Efficiently Produced Products [guanyu jingyibu zhichi guoyou kuisun gongye qiye youxiaolu, youxiaoyi chanpin shengchan de tongzhi], issued jointly by the PBOC, the SETC, and the State Bureau of Taxation in June 1998.

⁵¹ See Chinaonline, ‘China’s Bank Clean-up to Take Three Years- Official’ (October 25, 1999), available at <http://www.chinaonline.com/topstories/C9102114.asp>.

⁵² YK Mo of the BIS Hong Kong Office conducted a sensitivity test on the provisions required by the “big four” against their classified loans. The test was conducted on the assumption that the NPLs were 20% of total loans extended by the “big four”, of which 6% were irrecoverable loans and the remaining 14% and doubtful and substandard loans. The following provision requirements applied in the analysis: 100% for irrecoverable loans, 75% for doubtful loans and 15% for substandard loans. The results showed that the required amount of provision was RMB480-979bn as of end-1997. Taking the 25th and 75th percentiles, a reasonable amount would be RMB600-850bn, roughly 1.3-1.8 times the entire amount of the post-injection aggregate paid-in equity capital of the “big four”. The “big four” would probably need such amounts of additional fund injection to recapitalize in order to maintain an 8% capital adequacy ratio. See Mo YK, *supra* note 41, ‘Annex Sensitivity analysis on provisions for classified loans in the four state-owned banks’, at 109.

⁵³ Xie, Ping, a senior official of the PBOC, for example, when talking about the feasibility of the establishment of mandatory requirements on disclosure for financial institutions, cautioned that such requirements would jeopardize public confidence since all financial institutions have serious problems and wondered how long it would take to get ready to be able to implement disclosure requirements. See *Strengthening the Banking System in China: Issues and Experience*, BIS Policy Papers No. 7, 331 (October 1999).

2. The 1999 Practice

In 1999, four State-owned AMC's were established to take over NPLs from the "big four". The AMC's issues bonds guaranteed by the MOF to their respective banks in exchange for NPLs at their paper value.⁵⁴ Because the bonds issued in exchange of the NPLs are Treasury-backed bonds, this transaction is virtually an injection of capital into the "big four".

Compared to the special treasury bond injection in 1998, setting up AMC's to take over NPLs from the "big four" can avoid the potential costs of succumbing to the natural tendency of reducing the cost of bank recapitalization by underestimating the magnitude of NPLs or by overestimating the amount that ultimately can be recovered from borrowers.⁵⁵ Given the current quality of loan classification and poor disclosure practices in China, it is hard to make a proper capital injection once-for-all, whether in cash or in bonds. While to establish AMC's to issue bonds in exchange for NPLs of the "big four" at face value to some extent has avoided the difficulties in valuation.

D. THE CONFLICTS BETWEEN RECAPITALIZATION AND MARKET DISCIPLINE

1. Methods to Enhance Market Discipline: Asian Experience

A dilemma that faces governments attempting to restructure their banking system is always similar: The idea of a wholesale government rescue raises serious moral hazard problems, meaning a precedent is set whereby taxpayers will always pay for banker's mistakes. But, if the government pushes banks to raise private capital, the risk is that banks will try to conceal their problems from the investors whose support they are seeking.⁵⁶

⁵⁴ See Zhang, Chunlin, 'How to Appraise the Sustainability of Government Debt in China? [ruhe pinggu woguo zhenfu zhaiwu de ke chixxing]', *Economic Research Journal (jingji yanjiu)* No. 2, 66, at 66 (February 2000).

⁵⁵ Partial recapitalizations, as in the Hungarian case, could have undermined the incentive for a change in bank behavior going forward by increasing the possibility of future recapitalization. See Lardy, Nicholas R., *supra* note 28, at 159.

⁵⁶ See, e.g., Montagnon, Peter & Jacob, Rahul, 'Asian Recovery: Banking on Borrowed Time', *Fin. Times* (November 18, 1999). Cf. Stiglitz, Joseph E., *supra* note 24. Stiglitz argued that injection of capital into banks in China would not bear any moral hazards because most the NPLs were loans to SOEs under government instruction and banks should be allowed to operate in the new system with better balance sheets. Stiglitz, however, did emphasize that the recapitalization must be once-for-all. *Id.*

All “Asian crisis countries” faced this dilemma when various governments had to recapitalize ailing banks. Efforts were made by authorities in these countries to minimize the moral hazards accompanying the government bailout of banks. In all the countries, bank restructuring was linked with corporate sector restructuring;⁵⁷ initiatives were taken to strengthen prudential regulation and supervision, bank governance and market discipline, with the intention to bring domestic standards closer to internationally accepted practices.⁵⁸

Actually, the bank recapitalization itself in these crisis countries has been a process to enhance prudential regulation and supervision, bank governance and market discipline.

First of all, in all “Asian crisis countries”, the bank restructuring strategies relied on a tightening of rules for loan provisioning and observance of minimum capital requirements. This gave banks a basis for recognizing their losses based on international best practices, identifying their capital shortfalls, and putting forward recapitalization plans. In Thailand, for example, an 8.5% CAR for commercial banks applies in full while the loan loss provisioning requirements are increased each semester until the end of year 2000.⁵⁹ The principle that existing shareholders should bear losses until their capital has been fully written off was generally applied in all the “Asian crisis countries”, although in some countries shareholders were left with nominal stakes to take into account legal restrictions on a full write-down or to avoid costly legal challenges by the old shareholders.⁶⁰

Second, as mentioned before, authorities in “Asian crisis countries” endeavored to achieve a private sector-based resolution, rather than complete State bailout of distressed banks.

Moreover, public support was conditioned upon matters such as cost reduction, and increases in return on assets. The South Korea authorities, for example, requested from banks with CARs below 8% self improvement plans to reach that threshold, including contributions

⁵⁷ See Balino, Tomas J. T., Enoch Charles *et al.*, *supra* note 3, at 63-4.

⁵⁸ *Id.*, at 64.

⁵⁹ To ensure the safety of the banking system, the government introduced strengthened provisioning rules in 1998 as part of the financial reform program. Under the rules, all banks must have provisions for 20% of bad loans by the end of 1998, rising by 20 percentage points every six months and to 100% by end-2000. See, e.g., Bardacke, Ted, ‘Thailand: Banks Post Big Losses’, *Fin. Times* (January 25, 1999); ‘Thailand: Provisions Push Banks Deep into Loss’, *Fin. Times* (January 22, 1999).

⁶⁰ E.g., in Thailand, the shares of owners in intervened banks have been written down to token values. Furthermore, in Indonesia, the authorities pursued former shareholders of failed banks for personal indemnification for past central bank liquidity support in those cases where banks have been in violation of prudential regulations, especially for connected lending. See Balino, Tomas J. T., Enoch Charles *et al.*, *supra* note 3, at 51.

of new capital from existing or new shareholders. Approval of those plans was a requirement for banks to keep their license and for them to receive public sector support through the sale of NPLs to KAMCO or in the form of equity. Memoranda of Understanding (MOUs) were used to document the approval of the plans and the conditions attached to them. The latter typically included operational improvement benchmarks on matters such as cost reduction, labor shedding, and rate of return on assets.⁶¹

2. Implications for China

The government recapitalization of the “big four” bears moral hazards as well. The State recapitalization of banks, and the money being poured by the MOF into the AMCAs would give banks the expectation of government bailout in the future.

Some cautions have already been taken to avoid this moral hazard. A cut-off has been made clearly.⁶² Banks was warned that the money being poured by the MOF into the AMCAs would be the last such injection and bankers would henceforth be subject to strict new disciplines.⁶³ Besides, the government divided the NPLs in the “big four” into three categories: NPLs issued after January 1, 1996, irrecoverable loans issued before January 1, 1996, and NPLs other than irrecoverable loans issued by January 1, 1996. The AMCAs only take over the third category of NPLs, while the banks are required to deal with the first and second categories of NPLs themselves.⁶⁴ The rationale behind the cut-off is that as NPLs issued before 1996 were mostly loans issued under the credit plan or government instruction, banks should not be required to be responsible for them. After the implementation of the Commercial Banking Law on July 1, 1995, commercial banks in China, including State commercial banks, are required to operate on commercial bases. NPLs issued afterwards therefore should be dealt with by banks themselves rather than be bailed out by the

⁶¹ See, e.g., Park, Yung Chul, ‘The Banking Reform in Korea: Issues and Challenges’ in *Strengthening the Banking System in China: Issues and Experience*, BIS Policy Papers No. 7, 263, at 264 (October 1999).

⁶² The importance of the cut-off has been emphasized by Janos, Kornai. See Kornai, Janos, *Highway and Byways*, 123 (1995).

⁶³ Dai’s remarks came as the first AMC just became operational at one of the “big four”. See Montagnon, Peter & Harding, James, ‘China: Bank Cut Non-performing Loans’, *Fin. Times* (September 13, 1999).

⁶⁴ Section 4, the Proposal of the PBOC, MOF and CSRC on the Establishment of China Cinda Assets Management Corporation, issued by the General Office of the State Council on April 4, 1999 (hereinafter referred to as “the Proposal on Cinda AMC”); and also Zhao, Haikuan, *supra* note 14, at 27.

government.⁶⁵ More importantly, the “big four” are required to sign “governance contracts” with the PBOC to set out performance goals and to establish supervisory boards.⁶⁶

As argued above, it is difficult for the “big four” to raise private funds at this moment. At least in one point, however, China could follow these Asian countries, *i.e.*, to enhance prudential banking regulation and supervision, and to promote bank internal controls, so that the increase in NPLs can be curbed.

III. CHINA’S AMC PROGRAM

A. WHY ASSET MANAGEMENT COMPANIES IN CHINA?

How to deal with NPLs accumulated with a country’s banking system is one of the most critical and complex questions for bank restructuring. The two extreme choices include setting up a government agency with full responsibility of acquiring, restructuring, and selling the assets or letting banks manage their own NPLs.⁶⁷ Both approaches have been employed to tackle NPL problems in different countries. The former has been employed in countries such as Malaysia and South Korea, where State-owned centric AMCs were established to tackle the mass of NPLs. The latter approach was used in Poland.⁶⁸ In-between these two extremes include the approach employed in Thailand, where the government principally acted as an intermediary for the market-based sale of NPLs while at the same time encouraged private asset management through tax incentives.⁶⁹

1. The Polish Experience: Leaving the NPLs inside the Banks

⁶⁵ See Zhao, Haikuan, *supra* note 14, at 26.

⁶⁶ See, *e.g.*, the IMF, *International Capital Markets: Development, Prospects, and Key Policy Issues*, 74 (September 1999).

⁶⁷ See Balino, Tomas J. T., Enoch Charles *et al.*, *supra* note 3, at 7 & 53.

⁶⁸ See Montes-Negret, Fernando & Papi, Luca, *The Polish Experience in Bank and Enterprise Restructuring* (the World Bank, November 1996).

⁶⁹ Thailand followed the exactly US RTC model. FRC in Thailand was authorized to take over and handle the NPLs of closed finance companies; while in the US, RTC was established to close insolvent S & Ls using the new stream of funding. See, *e.g.*, Lim, Alvin K., ‘The S & L Crisis Revisited: Exporting An American Model to Resolve Thailand’s Banking Problems’, 9 *Duke J. Comp. & Int’l L.* 343 (Fall, 1998).

There was a U-turn in early 2001, however. A state agency was created to buy up most NPLs from private commercial banks, in an intention to use the government’s leverage as major creditor to promote a fundamental corporate restructuring. See Kazmin, Amy, ‘Bangkok to Buy Banks’ Bad Debts’, *Fin. Times* (February 25, 2001); ‘Thais Unveil Private Bank Debt Deal’, *Fin. Times* (March 9, 2001).

The Polish government chose, in 1990, to leave NPLs inside the banks. Banks in Poland were required to separate irregular credits from regular credits and establish separate workout departments for irregular credits. These workout departments were set up and staffed with experts from outside the banks, with external technical assistance provided by international donors. Accountability was enforced by the bank supervisory board and a special unit of the Ministry of Finance, which monitored performance against the work-out departments' detailed business plans.⁷⁰

The following paragraph illustrates the Polish Government's motivations behind that decision:

We did not believe in our ability to create, within a reasonable time, a strong central institution in terms of the high quality of its staff and internal organization. Nor did we believe in the possibility of devising an adequate incentive system that would ensure the institution's active approach toward restructuring SOEs. We did not believe that such an institution could resist political pressure. We also felt that the centralized solution did not address the causes of the problem, which we believed lay primarily in the banks' lack of experience in handling credit. By painlessly removing the burden of bad debt from the banks, the centralized approach creates a danger that a bad loan portfolio will re-emerge in the near future. It does not contribute to enhancing the banks' experience in conducting credit operations and facing bad debt situation. Instead we recapitalized the banks to such an extent that they were able to create adequate provisions for the bad loans. The amount of *ex ante* recapitalization was a function of an estimate of the bad debts that could be recovered, so as to introduce an incentive to remove as much debt as possible.⁷¹

There are disadvantages with the Polish approach, however. First, leaving NPLs with banks may result in NPLs remaining on the bank balance sheets for a long period until the actual write-off or recovery. In a country with weak bankruptcy proceedings, this can take years. During that period banks will be reporting high (albeit maybe substantially reserved) levels of NPLs, damaging confidence in the banks and absorbing the attention of their managements. Second, because it takes time for banks to build up adequate loan loss provisions or write off NPLs, this approach also allows for the possibility of regulatory forbearance. Third, because banks do not sever their ties with bad debtors, old debt may thus be financed with new loans.⁷² Fourth, the Polish approach can only be effective when "banks

⁷⁰ See Montes-Negret, Fernando & Papi, Luca, *supra* note 68, at 10.

⁷¹ See Kawalec, Stefan, Sikora, S & Rymaszewski, P, 'Dealing With Bad Debts: The Case of Poland', in Caprio, Gerard, D Fokerts-Landau and Lane, T D, *Building Sound Finance in Emerging Market Economies* (the IMF 1994).

⁷² To avoid this disadvantage, the Polish government had to pass legislation to prevent banks from extending new credit to enterprises whose debt had been placed in the bad loans portfolio, unless such credit was given in connection with a conciliation procedure. Banks were also subject to a two-year deadline to either recover the

have sufficient skills and resources to deal with their problem” and when the restructuring of loans is limited to “case by case resolutions that have little economy-wide impacts.”⁷³

It might be safe to conclude here that when banks have little leverage to impose the reorganization of troubled firms, and when bankruptcy procedures function poorly, removing the loans from the banks and placing them in a specialized AMC appears to be a better solution.⁷⁴

2. Advantages and Disadvantages of the Specialized Agency Solution: the Experience of “Asian Crisis Countries”

A specialized agency can be justified for its following advantages⁷⁵ compared to letting banks manage their own NPLs: (1) From the macro-economic point of view, by taking bad assets from banks, AMCs can help banks meet risk-based capital requirements and other obligations. Banks with clean balance sheets will have more credit funds for the real economy. This cannot be achieved if banks have to deal with NPLs themselves.⁷⁶ (2) Clean balance sheets allow for greater transparency — tighter accounting standards and more rigorous prudential supervision — to be introduced. This is especially important for countries lacking appropriate banking regulation and supervision. In these countries, having the banks managing their own NPLs may make it easier for banks to hide issues of malpractice behind the NPLs.⁷⁷ (3) Establishing AMCs can concentrate the limited human skills and other resources available for debt recovery. A specialized agency is required because the task of

bad loans or obtain bankruptcy decision. *See, e.g.,* Dornbusch, Rudi & Giavazzi, Francesco, *supra* note 34, at 51.

⁷³ *See* Sheng, Andrew, *supra* note 6, at 41.

⁷⁴ *See* Dornbusch, Rudi & Giavazzi, *supra* note 34, at 51-2. The U-turn in Thailand serves as a good example for this points, *supra* note 69 and the accompanying text.

⁷⁵ These advantages are recognized by Chinese scholars as well. *See, e.g.,* Zhu, Ming & Huang, Jinlao, ‘On China’s Assets Management Corporations [lun zhongguo de zichan guanli gongsi]’, *Economic Research Journal* No. 12, 3, at 4 (December 1999).

⁷⁶ *E.g.,* Nozomu Kunishige, an analyst at Lehman Brothers, when commenting on the bulk bad loan disposal by Bank of Tokyo-Mitsubishi Ltd, said, “Even banks say they have finished putting aside reserves for their bad loans, there was always the possibility that asset prices would fall further, undermining the value of collateral. But by removing bad loans from their balance sheet, banks will be able to use funds more freely, for example on new areas of business.” Quoted in Dow Jones News Service, ‘BOT-Mitsubishi Shrs Up After Bulk Bad Loan Disposal Report’ (April 4, 1999).

⁷⁷ *E.g.,* in Indonesia, the idea to have private AMCs to deal with failed banks were ruled out due to government concerns that associates of some of the failed banks could set up private AMCs to circumvent rules for pricing and prudent governance. *See* Balino, Tomas J. T., Enoch Charles *et al.*, *supra* note 3, at 57.

dealing with NPLs is fundamentally different from that of making new loans and is often beyond banks' management capacity.⁷⁸ (4) The unloading of NPLs from banks to AMC's would enable banks to focus their resources on managing good assets and improving operations.⁷⁹ (5) A centralized AMC can be given special legal powers to expedite loan recovery and bank restructuring. (6) A centralized AMC centralizes ownership of collateral, thus providing more leverage over debtors and more effective management.⁸⁰

It is because of its above-mentioned advantages that the AMC approach has been perceived as the optimal choice to deal with bank NPLs for countries facing systemic NPL problem. The IMF, for example, when organized a bailout package for Indonesia, ruled that banks' NPLs had to be handed over to the Indonesia Bank Restructuring Agency (IBRA).⁸¹

There are risks with a centralized AMC, however, as clearly identified by the Polish authorities: low quality of the staff, no experience with loan workouts, a bureaucratic organization, weak incentives, *etc.* Besides, a centralized AMC often does not have enough resources to tackle the NPLs in individual banks promptly, and that will cause delay in resolving the problem. In South Korea, for example, many banks are now considering NPL-backed quasi securitizations,⁸² partly driven by the slow pace of asset resolution by the Korean Asset Management Corporation (KAMCO).⁸³ Furthermore, a centralized AMC is often State-owned, which means costs to taxpayers and difficulties in determining transfer prices if dealing with private banks.⁸⁴ Last but not least, values of acquired assets erode faster when they are outside a banking structure because a centralized AMC does not have

⁷⁸ See the World Bank, *Global Economic Prospects 2000 Report*, 86-7 (December 1999).

⁷⁹ It was reported that the ICBC, BOC, CCB and BOCOMS all experienced significant growth in profits in the year 2000, making 2000 the best year for business in six years, partially attributable to the removal of NPLs from their balance sheets. See Chinaonline, 'Banks Cash in on Best Business in Six Years' (January 19, 2001), available at '<http://www.chinaonline.com/topstories/010119/1/B201011501.asp>'.

⁸⁰ See Balino, Tomas J. T., Enoch Charles *et al.*, *supra* note 3, 'Box 8. Advantages and Disadvantages of a Centralized Public AMC' at 57.

⁸¹ A centralized public AMC became fully operational in April 1998 within the IBRA to purchase loss loans from State banks, and private banks, eligible under the government's joint recapitalization scheme. See, e.g., Xinhua English Newswire, '11.5 Bln Dollars in Indonesia Bad Bank Assets Seized' (April 3, 1999), available at '1999 WL 7931247'.

⁸² See Chu, Vivian, 'Korea's Kookmin Debuts Own NPL-Backed Bond', *Emerging Mkts. Debt Rep.* (December, 13 1999), available at '1999 WL 26056658'.

⁸³ Bankers expect that once KAMCO starts buying Daewoo bonds from investment trusts, they may have no more capacity to buy NPLs from banks. *Id.*

⁸⁴ This is due to the valuation difficulties for impaired assets. AMC asset purchases at inflated values amount to a back-door recapitalization of the bank selling the assets and a bailout of its shareholders. If the prices are set too low, banks may be deterred from selling their NPLs to the AMC because the sale forces immediate recognition of the value of the loan. See Balino, Tomas J. T., Enoch Charles *et al.*, *supra* note 3, at 57.

knowledge of specific borrowers. It is because of these disadvantages of a centralized AMC that at least one Asian crisis country — Thailand — chose a decentralized process encouraging each commercial bank to establish its own separate AMC, although a public AMC was established to purchase residual assets from the Financial Sector Restructuring Agency (FRA).⁸⁵

3. Implications for China

In China, the “big four” are entirely State-owned. A public owned AMC would not cause problems such as difficulties in determining transfer prices. And, because of the lack of resources of the banks to deal with the NPLs themselves, State-run AMCs become an inevitable choice. That does not mean, however, that China should not have AMCs run by banks themselves or other private parties. They can be developed to tackle NPLs in banks other than the “big four” and non-bank financial institutions. As will be discussed below, four State-owned AMCs have been established respectively for the “big four”. To avoid the disadvantages of a centralized AMC, China chose to have one specific AMC for each of the four largest State-owned banks.

B. CHINA’S AMC PROGRAM

In China, using intermediaries such as AMCs to solve the State commercial bank NPL problem was recommended as early as 1993.⁸⁶ Liu, Zhunyi and Qian, Yinyi proposed the establishment of an Enterprise-Bank Restructuring Fund to take over NPLs from banks and subsidize enterprises in difficulties for a fixed period of time.⁸⁷ Li, Daokui and Li, Shan later proposed to establish an Enterprise Restructuring Center to compensate banks suffering loss

⁸⁵ The structure in Thailand has been that the FRA was to auction off the assets of the closed financed companies, the State-owned AMC was set up to act as bidder of the “last resort” for assets of closed finance companies. *Id.*, ‘Table 9. Public Asset Management Companies in the Asian crisis countries’, at 56. The Thai Government had a policy U-turn in early 2001 by establishing a state agency to purchase most NPLs from the country’s financial institutions, however. *See supra* note 69 and the accompanying text.

⁸⁶ *See, e.g.*, Zhou, Xiaochuan, ‘The Restructuring of Bank-Enterprise Relationships [qiye yu yinhang guanxi de chongjian]’, *Gaige [Reform]* No. 6 (June 1993).

⁸⁷ *See* Liu, Zhunyi & Qian, Yinyi, ‘Proposals for Bank/Enterprise Financial Restructuring [guanyu zhongou de yinhang yu qiye caiwu chongzhu de jianyi]’, *Jingji yu Shehui Tizhi Bijiao* No. 5 (1994).

in enterprise restructuring.⁸⁸ Zhang, Chunlin suggested a split of State commercial bank NPLs, with banks taking care of those granted after 1996 and special intermediaries taking care of older NPLs and deciding the fate of debtor enterprises.⁸⁹

These proposals, however, were not applied until 1999. In January 1999, the State Council and the PBOC ordered that State commercial banks should move NPLs to special accounts and that AMC's should be formed to take NPLs from banks.⁹⁰ Four separate AMC's were established within a span of six months (April-October) in 1999 to handle NPLs of the "big four" respectively. They are: the Cinda AMC for the CCB, the Dongfang (Orient) AMC for the BOC, China Great Wall AMC for the ABC, and China Huarong AMC for the ICBC (see Annex V). On November 10, 2000, the State Council promulgated Regulations on Financial Asset-Management Companies, concluding the AMC program in China.⁹¹

AMC's in China are mandated to purchase, manage and handle NPLs from the banks respectively.⁹² There is a cutoff, however. AMC's in China only deal with the NPLs issued before 1996, with NPLs scheduled to be written off to be excluded from purchase.⁹³ NPLs granted after the beginning of 1996 are left to banks themselves.⁹⁴ By the end of June 2000, the four AMC's had taken over RMB1.3trillion (US\$157bn) from the "big four", marking the basic completion of the transfer of NPLs from the "big four".⁹⁵

⁸⁸ See Li, Daokui & Li, Shan, 'A New Idea for SOEs' Debt Restructuring [guoyou qiye zhaiwu chongzhu de yige xin shilu] in Wu, Tianlin (ed.), *Theory and Practices of State Sector Debt Restructuring* [guoyou jingji zhaiwu chongzhu lilun yu shiwu], 77 (1997).

⁸⁹ See Zhang, Chunlin, 'On SOEs' Debt Problem', in Wu, Tianlin (ed.), *Theory and Practices of State Sector Debt Restructuring* [guoyou jingji zhaiwu chongzhu lilun yu shiwu], 96 (1997).

⁹⁰ See, e.g., Chinaonline, 'China's Troubled Financial Health Reflected in State Commercial Banks' (February 5, 1999), available at 'http://www.chinaonline.com/top_stories/industry_b2_99020516.html'; and 'China's State-Owned Banks to Sell Bad Loans; Establish Asset Management Companies' (January 19), available at 'http://www.chinaonline.com/top_stories/today_b2_99011911.html'.

⁹¹ Regulations on Financial Asset-Management Companies [jinrong zhichan guanli gongshi tiaoli], promulgated by the State Council on November 10, 2000 and effective as of the same date (hereinafter referred to as 'AMC Regulations').

⁹² *Id.* art. 2.

⁹³ The Proposal on Cinda AMC, *supra* note 64, sect 4; O'Neill, Mark, 'Asset Manager Launch Hailed But Buyers May not Come Running', *South China Morning Post* 4 (April 21, 1999); and also China Daily, 'China: Firm Set up to Manage Assets' (April 21, 1999), available at '1999 WVL 5969010'.

⁹⁴ Upon special approval of the State Council, the AMC's can purchase beyond the stipulated scope or amount. AMC Regulations, *supra* note 91, art. 11.

Cinda, for example, in addition to assuming NPLs from CCB, had taken over RMB100bn NPLs from the State Development Bank by the end of 1999. See, e.g., Chinaonline, 'Damage Control Xinda AMC Launches 38 Debt-for-Equity Projects' (September 14, 2000), available at 'http://www.chinaonline.com/issus/econ_news/currentnews/secure/B200091307.asp'.

⁹⁵ See, e.g., Chinaonline, 'Asset Management Cos. Receive US\$157bn of Bad Assets from Banks' (August 3, 2000), available at 'http://www.chinaonline.com/issues/econ_news/currentnews/secure/B200072705.asp'. As a result, the amount of NPLs for the "big four" dropped 10%, and their CAR rose from 3% to 8%. See

AMCs in China are under the supervision of the MOF, the PBOC and China Securities Regulatory Commission (CSRC).⁹⁶ The MOF carry out supervisions over AMCs' financial situation.⁹⁷ AMCs' operations are supervised mainly by the PBOC, with their securities business supervised by CSRC.⁹⁸

The AMCs set branches in main cities.⁹⁹ By end-February 2000, for example, Cinda had set branches in Urumqi¹⁰⁰ and Wuhan.¹⁰¹

C. CHARACTERISTICS OF CHINA'S AMCS

1. Bank-Specific AMCs

China's AMC program bears some unique features in the sense that State-owned AMCs independent of banks are established to deal with NPLs of respective banks. This distinguished China's AMC program from the Resolution Trust Corporation (RTC) practices in the US, and from the AMC practices in South Korea and Malaysia, where State-owned centralized AMCs were established to tackle the NPLs of the whole financial system. China's AMC practices are also quite different from the practices in Poland, where banks were left to deal with their NPLs themselves.

This quasi-centralized approach based on the primary role of State-owned AMCs makes sense in China for many reasons. First, the bank-specific structure guarantees that NPLs in each of the "big four" would be tackled without delay. Given the huge amount of

Chinaonline, 'A Little off the Top: Big 4 Banks Drop 10% of Bad Debt' (December 19, 2000), available at '<http://www.chinaonline.com/industry/financial/newsarchive/secure/2000/December/c00121506.asp>'.

⁹⁶ AMC Regulations, *supra* note 91, art. 4.

⁹⁷ To supervise AMCs more efficiently, the MOF set up a financial supervisory and inspection office in each city where there is an AMC outlet to oversee their financial situation. See China Daily, 'China: AMCs Enhance Financial System' (October 24, 1999).

⁹⁸ See, e.g., Chinaonline, 'China Get Second Asset Mgmt Co., Two More This Week' (October 18, 1999), available at '<http://www.chinaonline.com/industry/financial/currentnews/secure/C9101508.asp>'; Chinaonline, 'China Gets Third Asset Management Co., Another Wednesday' (October 18, 1999), available at '<http://www.chinaonline.com/topstories/B2-99101805.asp>'.

⁹⁹ AMC Regulations, *supra* note 91, art. 7. Accordingly, an AMC must obtain the approval of the MOF to set up branches.

¹⁰⁰ On September 6, 1999, Cinda set up an office in Urumqi. That was the first office of the AMC outside Beijing. See Shi, Runmei, 'Cinda AMC Set up Office in Urumqi[xinda zichan guanli gongshi urumuqi bangshichu chengli]', *Jinrong Shibao*, 12 (September 9, 1999).

¹⁰¹ See, e.g., Chinaonline, 'Four Asset Management Firms Open Shop in China's Wuhan' (February 18, 2000), available at '<http://www.chinaonline.com/topstories/000218/2/C00021706.asp>'. The four AMCs' Wuhan

NPLs accumulated in the “big four” and the urgency to release the banks from these burdens, it is better to have four AMCs rather than just one. Second, the bank-specified structure can to some extent avoid one disadvantage of a centralized structure: lack of knowledge of the borrowers. The bank-specific structure allows AMCs to make good use of banks’ information about the debtors.¹⁰² Moreover, because the AMCs are bank-specific, most of their staffs are recruited from within the respective banks. These staff, when finished with their task at the AMCs, will bring back to banks their experiences and skills acquired from their posts at the AMCs.¹⁰³

2. State Ownership and Heavy Administrative Color

AMCs in China are owned by the State. The MOF capitalized them with RMB10bn each.¹⁰⁴ AMCs in China also bear heavy administrative color. They are put at the same level as the PBOC on the “administrative ladder”. The board members of AMCs are mostly government officials, rather than experts in law, accounting or finance.¹⁰⁵

The State ownership of AMCs and their administrative color raise a question about whether they can deal with the NPLs better than State-owned banks.¹⁰⁶ Like State-owned banks, AMCs in China are vulnerable to government interference. The problem of administrative intervention was so serious that Zeng Peiyan, chairman of the State Development and Planning Commission had to call publicly in the People’s Daily for tightening the screening of firms eligible for debt-equity swaps so as to curb the “administrative intervention” in the selecting process.¹⁰⁷

Furthermore, the State-ownership means that the State will eventually have to take care of the NPLs that the AMCs fail to workout or recover.¹⁰⁸ The State-ownership in this

branches each takes on the delinquent assets from the provincial branch of the respective State commercial banks. *Id.*

¹⁰² This advantage, which is strong in market economies, might be mitigated in China and other transition economies where the information system is weaker and informative asymmetries more severe.

¹⁰³ See, e.g., Zhu, Ming & Huang, Jinlao, *supra* note 75, at 5.

¹⁰⁴ AMC Regulations, *supra* note 91, art. 5.

¹⁰⁵ See, e.g., Zhu, Ming & Huang, Jinlao, *supra* note 75, at 4.

¹⁰⁶ See, e.g., Chinaonline, ‘Economists Examine China’s Potential Debt-to-Equity Conversion’ (September 21, 1999), available at ‘<http://www.chinaonline.com/industry/fina.../currentnews/open/B2-99090711-SS.doc.asp>’.

¹⁰⁷ See Reuters English News Service, ‘China: China Planner Seeks to Cool Fevour on D/E Swaps’ (November 5, 1999).

¹⁰⁸ AMC Regulations, *supra* note 91, art. 32, which reads as follows:

sense creates disincentives for AMC's to do their best to avoid unloading debt onto the government.

3. Wide Business Scope and Powers

AMCs in China are granted wide business scope and powers. According to the AMC Regulations, AMC's can carry out the following business activities in managing and handling NPLs purchased from State-owned banks: (1) debt collection; (2) leasing, transferring or restructuring the assets they take over from the banks; (3) debt-equity swaps and holding enterprise equity for a certain period of time; (4) listing recommendation and securities underwriting to the extent of NPL management; (5) issuing financial bonds and borrowing from financial institutions; (6) financial/legal consulting and project evaluation; and (7) other business activities authorized by the PBOC and CSRC.¹⁰⁹

To facilitate their operation, the State Council grants AMC's preferential treatment. AMC's are exempt from taxes in their purchase of NPLs from State-owned banks and in their managing, handling and disposal of NPLs.¹¹⁰ They are also exempt from administrative charges such as registration fees.¹¹¹

D. PROBLEMS WITH CHINA'S AMC PROGRAM AND RECOMMENDED SOLUTION

AMCs in China are modeled on the US RTC, which successfully solved the S & L crisis in early 1990s.¹¹² Dai, Xianglong said that the objective of the AMC program in China is "to make credit officers accountable for their practices...to deal with non-performing assets in a clear, specific manner [and] to improve the balance sheets of the State-owned banks."¹¹³

For the final losses incurred during the handling of NPLs by financial asset-management companies, the Ministry of Finance shall propose a solution to be executed at the approval of the State Council.

¹⁰⁹ *Id.* art. 10.

¹¹⁰ *Id.* art. 28.

¹¹¹ *Id.*

¹¹² This was admitted by China's Premier Zhu Rongji. See Associate Press Newswires, 'Clinton Zhu Text By the Associated Press' (April 9, 1999). RTC's former chairman, L. William Seidman, advised the Chinese government for the program. See Pornfret, John, 'China Set to Tackle Economic Woes; Government Plan Readied to Deal With Massive Bank Debt', *The Washington Post*, A21 (January 16, 1999). The Premier Minister might have not realized that the RTC in the US was in charge of closing insolvent S & Ls rather than taking NPLs from afloat banks.

¹¹³ Quoted in Harding, James, 'China: Market Differences Emphasized', *Fin. Times* (January 28, 1999).

Whether the AMC in China can achieve these goals, however, remains doubtful.¹¹⁴ There are problems with China's AMC practices.

1. The Dilemma Faced by Chinese AMCs

AMCs in China are not only tasked to release banks of their NPL burdens, but also mandated to help SOEs get rid of their troubles.¹¹⁵ Although AMCs in China are officially defined as non-bank financial institutions,¹¹⁶ they have to carry out some duties that should be carried out by government agencies.¹¹⁷ They are mandated to rescue as many "viable" SOEs as possible. Foreclosure and bankruptcy can only be applied as the last resort by AMCs in China.¹¹⁸ Thus, AMCs in China are actually facing a dilemma. On the one hand, they are creditors to SOEs and should recover as much as possible from their SOE debtors. On the other hand, they must sometimes sacrifice their creditors' rights to help SOEs out of their difficulties. This dilemma in some terms greatly limits AMCs' discretion in managing bank NPLs and imposes doubts on whether AMCs can carry out their missions as successful as their US counterpart.¹¹⁹

It will be unrealistic to propose that China ignore its SOE problem and put emphasis solely on the bank side. First, the "big four", although technically insolvent, are not suffering any liquidity problem. There are no obvious bank runs or bank panic in China. The concerns of the policy-makers, therefore, are mainly on negative effects of the NPL problem on the real economy.¹²⁰ This consideration, together with the fact that both bank creditors and enterprise debtors are State owned, decides that the solution to the NPL problem cannot only

¹¹⁴ See, e.g., Reuters English News Service, 'China: China's WTO Deal Heralds Radical Banking Reform' (November 16, 1999).

¹¹⁵ See Zhu, Ming & Huang, Jinlao, *supra* note 75, at 3.

¹¹⁶ AMC Regulations, *supra* note 91, art. 2.

¹¹⁷ See Zhu, Ming & Huang, Jinlao, *supra* note 75, at 4.

¹¹⁸ See, e.g., Foo Choy Peng, 'China Cinda Seeks Foreign Help', *South China Morning Post*, 8 (May 5, 1999).

¹¹⁹ The RTC in the US carried out a strategy of disposing of the impaired assets as quickly as possible and maximizing the recovery from the disposal. In its six years of existence, the RTC in the US had resolved 747 insolvent thrifts and recovered \$395bn of the \$456bn in its charge. See Foust, Dean, 'The RTC's Epitaph: It Worked', *Bus. Wk.*, 29 (January 15, 1996).

The RTC had accomplished its mission so expeditiously that it shut its doors one year ahead of its December 31, 1996 sunset expiration date. See Lim, Alvin K., *supra* note 69, at 355-6.

¹²⁰ Banks trapped with huge amount of NPLs may become cautious on granting new loans. This cautiousness impedes the efficient implementation of "expansionary" monetary policy. See Zhu, Ming & Huang, Jinlao, *supra* note 75, at 3.

be based on banks' interest. Second, as a matter of fact, without solving the SOE problem, the NPL problem embarrassing the State commercial banks cannot be solved in reality.¹²¹

The Polish experience might have some relevance to policy-makers in China. To enhance market discipline on banks and enterprises, the Polish government required that financial cooperation between banks and nonviable enterprises be terminated and nonviable enterprises be liquidated, except where liquidation was considered unfeasible because of political or social-economic considerations. Such cases were treated under the terms of a decree enacted in October 1995, which allowed special budgetary allocations (Industrial Development Agency-IDA) supporting restructuring or managing the liquidation. To prevent banks from conditioning conciliation agreements on the provision of budgetary assistance, the decree stipulated that budgetary resources should support a conciliation agreement only if it was conducted by the IDA.¹²² The 1995 decree released commercial banks of the burden of subsidizing those "too big to fail" SOEs and facilitated their commercialization.

The current author would suggest that the Chinese government take care of those "too big to fail" SOEs itself, so that AMC in China can concentrate on solving banks' NPL problems. In other words, it should be the government's duty rather than that of the AMCs to bail out those economically and socially important SOEs.

2. The Dependence of AMCs on the Respective Banks

One advantage of AMCs over banks in managing bank NPLs is that AMCs will not be scared to investigate causes of NPLs. This advantage of AMC over banks will be lost, however, if AMCs are dependent on their banks.

It is officially declared that AMCs hold independent civil liability.¹²³ There remain doubts, however, that the AMCs in China can be independent of the banks in their operations, as they are supposed to be. All the four AMCs are carved out of former investment and trust companies subject to the respective banks.¹²⁴ Their staffs come from the

¹²¹ *Id.*

¹²² See Fernando Montes-Negret & Papi, Luca, *supra* note 68, at 10.

¹²³ AMC Regulations, *supra* note 91, art. 3.

¹²⁴ Huarong AMC is based on Huarong Trust & Investment of the ICBC. China Great Wall AMC is based on the Great Wall Trust & Investment of the ABC. Dongfang AMC is based on Dongfang Trust & Investment of the BOC. Cinda AMC is based on Cinda Trust & Investment of the CCB. These investment and trust

banks as well.¹²⁵ The supervisory boards of the AMCs comprise mainly officials appointed by the MOF, the PBOC, the State General Auditing Bureau, CSRC, and their respective banks.¹²⁶ Moreover, Their leadership appears to have close ties with the banks. For example, the State Council appointed Zhu, Dengshan, former vice president of CCB as Cinda's president, with Shi, chungui and Tian, Guoli, former vice and assistant presidents of CCB as Cinda's vice-presidents.¹²⁷

The dependence of AMCs on respective banks is to some extent inevitable in China. The AMCs lack a network of branch organizations like banks. So when they deal with local borrowers, they will have to rely on banks' branch networks. Besides, the banks have the knowledge about their borrowers, which is essential to debt collection and debt restructuring.

Lou, Jiwei, vice-minister of the MOF, required when speaking at the Great Wall's opening ceremony that the ABC should not completely stay away from operations of the Great Wall, although the later stood as an independent company — "the ABC should do it best to help the Great Wall with its asset recovering."¹²⁸

What the author would like to suggest here is that emphasis be placed on the accountability of AMCs. The State Council AMC Regulations provide that AMCs submit financial and statistical reports as well as other related materials in accordance with the requirements of the PBOC, the MOF, CSRC, and other related government department;¹²⁹ and accept the auditing supervision of auditing authorities according to law.¹³⁰ Whether these provisions can guarantee the accountability of AMCs, however, remains to be tested.

3. The Lack of Expertise and Experience

subsidiaries of commercial banks were "closed" by the government by February 1999. See Harding, James, 'China: Five More Trust to Be Closed', *Fin. Times* (February 3, 1999).

¹²⁵ The Proposal on Cinda AMC, *supra* note 64, sect. 2, which provides that staffs of Cinda should be mainly selected from the existing staff in the CCB. The main staff of AMCs is recruited from the State commercial bank employment pool. Only a handful of expertise is recruited from outside the banks. See, e.g., Zhu, Ming & Huang, Jinlao, *supra* note 75, at 5.

¹²⁶ The Proposal on Cinda AMC, *supra* note 64, sect. 2.

¹²⁷ See, e.g., Agence France-Presse, 'China Opens First Asset Management Company for Bad Loans', (April 20, 1999), available at '1999 WL 2586720'.

¹²⁸ See China Daily, 'China: New Company to Handle Assets' (October 19, 1999).

¹²⁹ AMC Regulations, *supra* note 91, art. 29.

¹³⁰ *Id.* art. 30.

Handling NPLs requires skills and experiences in various fields. The debt recovery process is quite complex, and involves the conversion of the NPLs into real or financial assets, then the restructuring of these assets into easily sellable forms, and finally the selling process to maximize the net sale value. AMC's in China are in desperate need of personnel with such expertise.¹³¹ Cinda might be an exception.¹³² Cinda's managers, for the most part, are sophisticated financial engineers.¹³³ But this is not the case for other three AMC's.

In this respect, China should learn from South Korea, where joint-venture AMC's are set up so as to use foreign expertise and experiences.¹³⁴ The State-run Korea Development Bank, for example, was reported to set up an AMC with Merrill Lynch & Co, and the US private-equity fund Lone Star Fund II.¹³⁵ According to the report, Lone Star would take care of NPLs, while Merrill Lynch would do research work for reinvestments, including the issuance of asset-backed securities.¹³⁶ In Taiwan, international financial companies were invited to invest in a new institution to auction off bad debts sold by the island's banks to asset management corporations.¹³⁷ Actually, even the RTC in the US relied heavily on expensive consultants because its fleeting life span made it difficult to recruit quality personnel.¹³⁸

The State Council Regulations on Financial Asset-Management Companies authorized AMC's to retain qualified intermediary institutions to take part in accounting, asset appraisal and legal services.¹³⁹ This may to some extent solve the problem. This author,

¹³¹ Zhou, Xiaochuan, chief executive and president of CCB, admitted that AMC's created to take over NPLs from banks were short of experienced and qualified personnel. See, e.g., Wang, Xiangwei, 'Debt-clearing Scheme May Face Hurdles Official Says Swaps Not "A Free Lunch"', *South China Morning Post* 3 (December 11, 1999).

¹³² Cinda is leading the way in restructuring and disposing of NPLs. See, e.g., Chinaonline, *supra* note 94.

¹³³ See Business Week, 'China's Bad-debt Cops Get Going' (October 11, 1999), available at '1999 WL 27295452'. Fang Xinghai, a general manager at CCB and one of the founders of Cinda, for example, earned a doctorate in economics at Stanford University and spent five years at the World Bank before joining CCB and overseeing Cinda's creation. *Id.*

¹³⁴ See Tarrant, Bill, 'South Korea: Analysis- Skorea Shifts to Tack on Asset Restructuring', Reuters English News Service (November 2, 1999).

¹³⁵ See Dow Jones Newswires, 'Korean Bank to Team with Two U.S. Firms to Manage Bad Loans', *Asian Wall St. J.*, 5 (December 7, 1999).

¹³⁶ See the Korea Herald, 'Korea Development Bank to Set up Asset Management Unit' (December 6, 1999), available in '1999 WL 29057585'.

¹³⁷ See, e.g., Dichie, Mure, 'Taiwan to Form Debt Auction Institution', *Fin. Times* (November 30, 2000).

¹³⁸ See Lim, Alvin K., *supra* 69, at 357. The RTC enlisted the aid of big-name consultants and investment banks to put together large deals so as to expedite the transactions and maximize value. *Id.* at 360.

¹³⁹ AMC Regulations, *supra* note 91, art. 27. Chinese AMC's actually went further to establish cooperative relationships with foreign intermediaries. For example, the Dongfang AMC signed a three-year cooperation memorandum with KAMCO in February 2001; and the Huarong teamed up with Ernst & Young to manage

however, still thinks that it is necessary for Chinese AMC's to recruit overseas professionals. For this purpose, the employment restriction will have to be relaxed or removed.¹⁴⁰

4. Difficulties in Evaluating Assets

Realistic valuation of bank NPLs is crucial for AMC's to take over NPLs from banks and to dispose of NPLs. There is no precise method for valuing NPLs in China, however, because of the lack of market prices for NPLs.¹⁴¹ Also, it is hard to value collateral, not only because of uncertain prices and limited markets, but also because of uncertainty as to whether and when the creditor can seize the collateral. Further, even if these problems can be solved, it takes time to evaluate NPLs in such a huge amount, while NPLs need to be taken over urgently from the banks.¹⁴²

The AMC's in China avoided the pricing problem by taking NPLs at their face value from the "big four".¹⁴³ This is quite different from the practices in "Asian crisis countries".¹⁴⁴ Because both AMC's and banks are publicly owned, the moral hazard problem is not so serious. Face-value takeover, however, will have some disincentives for banks to help AMC's recover and restructure debts.¹⁴⁵ Besides, because the NPLs were taken from banks at face

assets. See Chinaonline, 'Chinese, South Korean Firms Sign Nonperforming Asset Management Agreement' (February 12, 2001), available at <http://www.chinaonline.com/topstories/010212/1/C01020508.asp>; 'Huarong Asset Management Partners with Ernst & Young' (February 26, 2001), available at <http://www.chinaonline.com/topstories/010226/1/C01022102.asp>.

¹⁴⁰ It was reported that China's financial institutions below the provincial level are opening up leadership and upper-management posts to talented personnel from other industries and even from overseas. This decision was reached at the China National Financial System Organization Meeting held on Jan. 9, 2001. See Chinaonline, 'Financial Institutions Woo Overseas Professional' (January 11, 2001), available at <http://www.chinaonline.com/topstories/010111/1/B101010901.asp>.

¹⁴¹ According to the International Valuation Standards Committee (IVSC), Emerging market economies such as China often struggle with asset valuation, as individuals and companies have widely divergent ideas about the worth of assets where markets are not fully in place. The IVSC is a London-based organization formulating and promoting international valuation standards. See Chinaonline, 'Beijing Reveals New Assets Valuation Rules' (November 17, 1999), available at <http://www.chinaonline.com/industry/financial/NewsArchive/Secure/1999/November/B2-99111603.asp>.

¹⁴² See, e.g., Zhu, Ming & Huang, Jinlao, *supra* note 75, at 6.

¹⁴³ AMC Regulations, *supra* note 91, art. 12, which reads as follows:

Within the amount stipulated by the State Council, a financial asset-management company purchase at book value related loan principal and corresponding interest claims receivable charged to profit and loss. Interest claims receivable not charged to profit and loss shall be transferred without compensation.

¹⁴⁴ In Indonesia, NPLs were taken from banks at zero value. In South Korea, the discounts are 45% of face value for secured loans and 3% for unsecured loans. In Malaysia, the average discount has been 37% (excluding one large loan, it has been 60%). See Balino, Tomas J. T., Enoch Charles *et al.*, *supra* note 3, 'Table 9. Public Asset Management Companies in the Asian Crisis Countries' at 53.

¹⁴⁵ Proper transfer pricing is of key importance for the incentive structures for both the AMC and the banks — there is a need to set a system that provides the right balance. Excessive prices for NPLs may induce banks to

value, it is hard to appraise how well the AMCs have done their job¹⁴⁶ and creates disincentives for AMCs to maximize the recovery of NPLs.¹⁴⁷ The State Council AMC Regulations provide that the MOF should determine the operational objectives for handling NPLs by AMCs according to the quality of the NPLs and carry out the evaluation and supervision;¹⁴⁸ and that AMCs should make operational policies and related measures in accordance with their particularities, improve internal management, and establish internal restriction and motivation mechanisms.¹⁴⁹ The author doubts that these provisions can be carried out efficiently under the current face-value take-over.

The evaluation problem is not only limited to NPL takeover. NPLs will have to be valued when they are disposed of or restructured. There are already reported crosses between AMCs and enterprises on the valuation of enterprises' net asset in debt-equity swaps. The AMCs wanted a re-valuation of the net asset, while the enterprises insisted that book value be used.¹⁵⁰

E. IMMEDIATE LEGAL ISSUES RELATED TO CHINA'S AMC PROGRAM AND RECOMMENDED SOLUTION

AMCs in China are mainly operating on the basis of State Council Regulations¹⁵¹ and Decisions,¹⁵² and the SETC rules;¹⁵³ while in most other countries, AMCs are established and operated on the basis of laws adopted by legislators, usually the parliament. An AMC Law is needed in China because of the probable conflicts between AMC practices and laws adopted by the NPC or its Standing Committee. These conflicts can only be solved by special legislation of the NPC or its Standing Committee, rather than by State Council Regulations.

reduce their recovery efforts, which could lead to a general deterioration of credit discipline and loan values throughout the banking system. *Id.*, at 58.

¹⁴⁶ There is suggestion that an appraisal committee comprising officials from the MOF, the PBOC, State commercial banks, and AMCs should be established to assess the value of the NPLs taken from banks. *See, e.g.,* Zhu, Ming & Huang, Jinlao, *supra* note 75, at 6.

¹⁴⁷ *See, e.g.,* Li, Xia, "Debt-equity Swaps Should be Carried out on the Commercial Basis [zhaizhuanggu yunzhou ying gengjia shichang hua]", *Jingrong Shibao*, 12 (September 15, 1999).

¹⁴⁸ AMC Regulations, *supra* note 91, art. 24.

¹⁴⁹ *Id.* art. 25.

¹⁵⁰ *See, e.g.,* Chinaonline, 'China's Debt -Equity Program Has Yet to Be Implemented' (January 13, 2000), available at '<http://www.chinaonline.com/topstories/000113/C00011330.asp>'.

¹⁵¹ *E.g.,* AMC Regulations, *supra* note 91.

¹⁵² *E.g.,* the Proposal on Cinda AMC, *supra* note 64.

In addition to the need for a proper statute spelling out the statutes, the business scope, and powers of the AMCs, there are special legal issues that need to be sorted out by the NPC or its Standing Committee for AMCs to operate smoothly in China.

1. Immediate Legal Issues Related to AMC Practices in China

(i) *The Notification Obligation under the Contract Law*

Under the current Chinese Contract Law,¹⁵⁴ an obligee may assign its rights under the contract in whole or in part to a third party.¹⁵⁵ The obligee, however, should notify the obligor; and the assignment will not be binding upon the obligor if the obligee fails to give such notice.¹⁵⁶ The relevance of these provisions with the AMC practices is that banks must notify the borrowers when they sell NPLs to their AMCs. If banks fail to fulfill this notification obligation, when AMCs later on claim against the debtors, the debtors might be able to argue that AMCs do not have the authority to do so.

The absence of notice has other legal effects as well: (1) Debtors can continue to pay the banks rather than the AMCs. This, however, is not an objection because the AMCs might wish that their banks continued to collect loan principals and interests on behalf of them. (2) Debtors without notice can continue to acquire new set-offs and defenses. (3) It may be necessary for AMCs to join the banks in an action against debtors.

Although the State Council approved that once NPLs are purchased by AMCs, the AMCs become the creditors of the purchased loans and enjoy all the rights as creditors,¹⁵⁷ it is also required by the State Council that AMCs go through relevant procedures so as to enjoy the creditor's rights.¹⁵⁸ Even if this does not mean that appropriate notification must be made to debtors, whether the State Council's regulation can supersede the NPC legislation remains a problem. It is therefore necessary to pass special legislation to ensure that AMCs have a clear title to assets purchased and notification to borrowers is not necessary.

¹⁵³ See, e.g., Li, Xia, 'The Scope and Preconditions for Candidate Enterprises for the Debt-Equity Swap Scheme [shishi zhaizhuanggu qiye de fangwei yu tiaojian]', *Jingrong Shibao*, 12 (September 15, 1999).

¹⁵⁴ Contract Law of the People's Republic of China, adopted at the Second Session of the Ninth National People's Congress on March 15, 1999 and effective as of October 1, 1999.

¹⁵⁵ *Id.* art. 79.

¹⁵⁶ *Id.* art. 80.

¹⁵⁷ AMC Regulations, *supra* note 91, art. 13.

(ii) Procedural Requirements for the Transfer of Security Interests

Under the 1995 Security Law,¹⁵⁹ a lender's right can be secured by a guarantor, mortgage, pledge, lien, or earnest money.¹⁶⁰ The security interests, however, will not automatically transferred with the loans. Acquiring NPLs from banks does not necessarily mean that AMCs take over the security interests as well. The AMCs must go through certain legal procedures to be the new holders of the security interests.

In accordance with article 22 of the Security Law, if the security takes the form of personal guarantee, the guarantee contract does not need to be specifically assigned for the guarantor's obligation to remain unaffected by the assignment of the main right, unless the guarantee contract provides otherwise. If the security takes the form of mortgage, however, the AMCs will need to perfect its security interests by registration since unregistered mortgages will be ineffective against third parties or ineffective to all intents.¹⁶¹ This will be very burdensome for AMCs since they are taking NPLs and their collateral in large scale.

(iii) AMCs' Liabilities to Debtors

Another problem arises from art. 82 of the Contract Law. That article provides that upon receipt of the notice for assignment of obligee's rights, the obligor may assert against the assignee any of its defenses against the assignor. These provisions may prove troublesome for the AMCs. If there are no special provisions exempting AMCs from a lender's obligations, the borrowers may be able to ask AMCs to perform some obligations under original lending contracts. Because AMCs in China are now only in charge of NPLs extended by 1996, this concern, however, might only have remote theoretical significance.

¹⁵⁸ The Proposal on Cinda AMC, *supra* note 64, sect. 4.

¹⁵⁹ Security Law of the People's Republic of China, adopted at the 14th Session of the Standing Committee of the 8th National People's Congress on June 30, 1995 and effective as of October 1, 1995 (hereinafter referred to as "the Security Law").

¹⁶⁰ *Id.* art. 2.

¹⁶¹ Under the Security Law, a mortgage is not necessary to go through registration, although the parties may choose to have registered. *Id.* art. 43. For mortgages on real estate (including land use rights, buildings and forest), aircrafts, ships and vehicles, or mortgages on enterprise assets, including equipments or other movable property, registration is compulsory, however, the mortgage will not go into effect until it is registered. *Id.* arts. 41, 42. For mortgages on other properties, without registration, the mortgage cannot bind third parties. *Id.* art. 43.

2. Recommended Solution

To sum up, AMC in China are now operating mainly on the State Council Regulations, while there are provisions in the NPC legislation, such as the Contract Law and the Security Law, impeding the smooth operation of AMCs. Whether the State Council Regulations can challenge the NPC legislation remains a big problem. The Supreme People's Court, in an attempt to solve the possible problem in judicial practice, issued Provisions on Issues of the Application of Law Concerning Financial Asset Management Companies in Their Purchasing, Managing and Handling of State Bank's Non-performing Loans on April 11, 2001.¹⁶² Again, whether the Supreme People's Court has the appropriate authority to give such solution is an unsettled issue itself. It might be necessary that the NPC adopt special legislation to facilitate the smooth operation of AMCs in China.

IV. TWO MANAGEMENT STRATEGIES TOWARDS NPLS AND THEIR IMPLICATIONS FOR CHINA

Collecting NPLs from banks is only the first step. NPL management is a more crucial step for the success of the AMC program, as US Treasury Secretary Lawrence Summers said at a joint press conference with China Minister of Finance Xiang, Huaicheng — creating AMCs and having them take over NPLs from banks are not a total solution “because [this] does not ensure that assets will be recycled or restructured or managed rather than warehoused”.¹⁶³

Theoretically, there are two basic management strategies towards NPLs — asset management strategy (asset disposal) and loan management strategy (debt restructuring).

¹⁶² Provisions of the Supreme People's Court on the Application of Law Concerning Financial Asset Management Companies in Their Purchasing, Managing and Handling of State Banks' Non-performing Loans [zuigao renming fayuan guanyu shenli jinrong zhichan guanli gongsi shougou, guanli, chuzhi guoyou yinghang buliang diakuan xingcheng de zhichan de anjian shiyong falv ruogan wenti de guiding], adopted by the Supreme People's Court Judicial Committee at its No. 1167 meeting on April 3, 2001, published by the Supreme People's Court on April 11, 2001 and effective as of April 23, 2001. According to the Provisions, the banks should carry out its notification obligations by advertising the transfer of loans in major national or provincial newspapers to satisfy the notification requirements of the Contract Law. *Id.*, art. 6. The AMCs, when taking over mortgaged loans, are not required to go through the registration procedures and will be the new mortgagee automatically. *Id.*, art. 9.

¹⁶³ See Chinaonline, 'U.S. Treas Sec Comments on China's Asset Mgmt Cos.' (October 27, 1999), available at <http://chinaonline.com/topstories/c9102731.asp>.

AMCs must choose between these two strategies or implement a combination of these two strategies.

A. TWO MANAGEMENT STRATEGIES TOWARD NPLS

The overarching objectives for NPL management should be to maximize the value of the impaired assets in the system, to minimize fiscal costs, and to prevent credit discipline of borrowers from deteriorating.¹⁶⁴ Two basic strategies can be adopted to achieve these objectives (see Figure 2-1: NPL Management Strategies): one is an asset management strategy, applying to NPLs that are considered non-viable; the other is a loan management strategy, applying to loans that are considered viable.¹⁶⁵ The asset management strategy (asset disposal) emphasizes the quick disposal and cashing in of NPLs, while the loan management strategy (debt restructuring) puts emphasis on maximizing the recovery value of NPLs. While disposal of NPLs usually does not need the involvement of the courts, in some countries, collateral foreclosure will have to be carried out within the court system. Debt restructuring can be carried out within or out of the court system as well (see Annex VI).

As shown in Figure 2-1, in addition to loan collection and collateral foreclosure, asset disposal can take the form of loan sale, either privately or via public auction, or asset-backed securitization. As for debt restructuring, AMCs can tackle enterprises' arrears through debt-for-debt swaps or debt-equity swaps.

B. CHOOSING THE RIGHT STRATEGY: EXPERIENCE OF MALAYSIA AND SOUTH KOREA

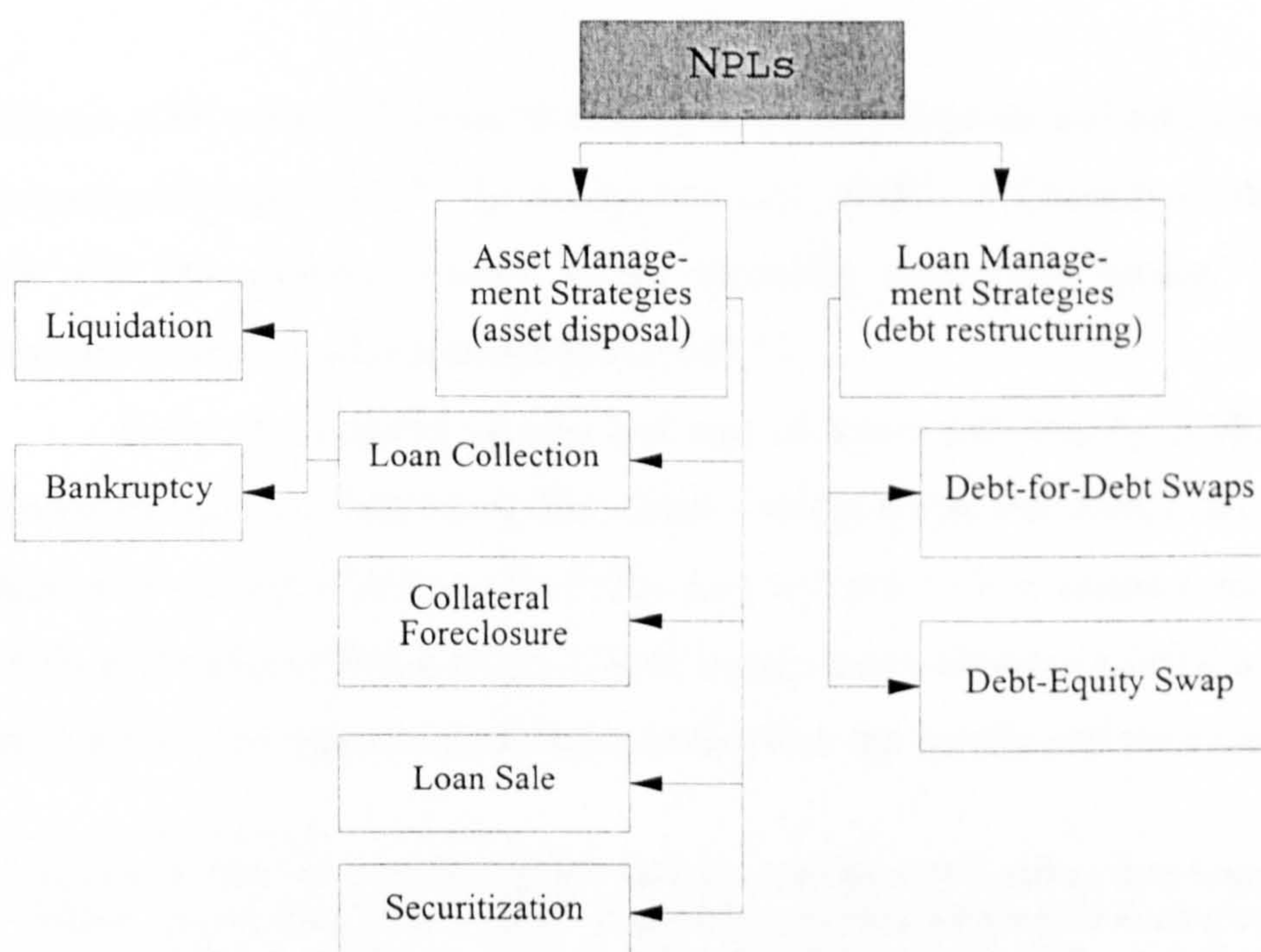
Whether a loan is viable or not is mostly a subjective judgment. Given the specific situation and needs of a country, AMCs in different countries apply different policies towards collected NPLs. Even in the same country, different policies are applied in different stages.

¹⁶⁴ See Balino, Tomas J. T., Enoch Charles *et al.*, *supra* note 3, at 53. These are the goals for Chinese AMCs as well. AMC Regulations, *supra* note 91, art. 3.

¹⁶⁵ These two terms are borrowed from the Guidelines issued by Malaysian Danaharta. See, e.g., Bernama, 'Danaharta to Finish Restructuring by June, Unveils Guidelines' (April 7, 1999), *available at* '1999 WL 5598028'; and AFX, 'Danaharta to Manage NPLs Based on Loan/Asset Management Strategies', *available at* '1999 WL 14937128'.

The AMC in Malaysia, the Malaysian Danaharta, for example, applied debt-restructuring strategies to most of the NPLs it collected. Under the guidelines issued by the institution, an asset disposal strategy should only be applied when loan restructuring has failed.¹⁶⁶ In an intention to maximize recovery on the assets collected, the Danaharta moved slowly to apply asset disposal strategy.¹⁶⁷

Figure 2-1: NPL Management Strategies



On the other hand, the South Korean KAMCO had mainly applied an asset disposal strategy by the end of 1999.¹⁶⁸ Since its designation in November 1997, KAMCO had acquired a total 55.9 trillion won in NPLs and disposed 20.9 trillion won worth as of the end of November 1999.¹⁶⁹ The quasi-government corporation disposed of bad assets by selling

¹⁶⁶ See, e.g., Bernama, *supra* note 165; and AFX, *supra* note 165. The guidelines, issued in April 1999, are supposed to promote transparency and provide the basis for borrowers and advisors to formulate workout proposals. The loan restructuring guidelines comprise four segments, namely, loan restructuring principles, guidelines for corporate borrowers, guidelines for individual borrowers and guidelines for guarantors.

¹⁶⁷ See Lopez, Leslie, 'Malaysia's Bad-Loan Agency is Moving Cautiously Toward Auctions', *Asian Wall St. J.* 4 (December 15, 1999).

¹⁶⁸ KAMCO's sale strategy is to dispose of NPLs in the fastest way possible, but in a manner that maximizes recovery value. See Balino, Tomas J. T., Enoch Charles *et al.*, *supra* note 3, 'Box 2. Korea KAMCO Operations' at 120.

¹⁶⁹ See Reuters English News Service, 'South Korea: KAMCO Plans to Issue Four Trillion Won ABS in 2000' (December 16, 1999).

NPLs to international investors, foreclosing and selling underlying collateral, selling NPLs in a public auction, or collecting on loans.¹⁷⁰ Asset-back securitization was introduced in 1999 as a way to dispose of NPLs as well.¹⁷¹ With the gradual recovery of the economy and the releasing pressures of NPLs on the financial system, the KAMCO decided to turn to the debt restructuring strategy at the end of 1999.¹⁷²

C. IMPLICATIONS FOR CHINA

China's AMCs are authorized to employ both asset disposal and debt restructuring strategies towards collected NPLs.¹⁷³ In reality, however, AMCs in China have been mainly carrying out debt restructuring strategy so far, especially debt-equity swaps,¹⁷⁴ although there are reported cases on bad asset disposal as well.¹⁷⁵

Given the quantity, quality and type of assets collected by AMCs in China, and the market demand for such assets, the author would propose that AMCs in China mainly apply a debt-restructuring strategy to the NPLs they collected. First, because most of the debtors are SOEs at the edge of bankruptcy, if AMCs apply debt collection widely, a massive bankruptcy of SOEs will be triggered and hence de-stabilize the society and the economy.¹⁷⁶ Second, the

¹⁷⁰ As of June 1999, for example, KAMCO had recovered about W 9 trillion from loans with a face value of W 17 trillion. Among them, NPLs with face value of W 2.9 trillion were sold to international investors, NPLs with face value of W 2.1 trillion were disposed of via foreclosure auction, NPLs with face value of W 0.2 trillion were sold publicly, while the lion's share of NPL face-valued at W 11.3 trillion were disposed through collection. See Balino, Tomas J. T., Enoch Charles *et al*, *supra* note 3, 'Box 2. Korea KAMCO Operations' at 120.

¹⁷¹ See Reuters English News Service, 'South Korea: S. Korea KAMCO to Issue 265bn Won ABS on Dec. 27' (December 15, 1999); and also Reuters English News Service, *supra* note 169.

¹⁷² See Tarrant, Bill, *supra* note 134.

¹⁷³ AMC Regulations, *supra* note 91, art. 10.

¹⁷⁴ Government officials were reportedly saying that debt-equity swaps should be the mainstay of future state sector reforms. See Dickie, Mure, 'China: Government Launches Fresh Drive on Bad Loans', *Fin. Times* (October 18, 1999). The State Council AMC Regulations devote a whole Chapter on debt-equity swaps. AMC Regulations, *supra* note 91, arts. 16-23.

¹⁷⁵ See, e.g., Chinaonline, 'For the First Time, China Auction off A Bad Asset' (November 23, 1999), available at '<http://www.chinaonline.com/topstories/99112202.asp>'; 'Sanlian Group to Invest in Troubled Baiwen Co.' (December 5, 2000), available at '<http://www.chinaonline.com/topstories/001205/1/C00120417.asp>'; and 'Huarong Asset Management Files Bad Debt Lawsuits' (January 2, 2001), available at '<http://www.chinaonline.com/topstories/010101/1/C00122706.asp>'; 'Huangrong Asset Management Looks Overseas for bad-debt buyers' (March 5, 2001), available at 'http://www.chinaonline.com/issues/econ_news/NewsArchive/secure/2001/March/B20102211.asp'; 'Huarong Asset Management Turns to Net to Unload Nonperforming Assets' (April 2, 2001), available at '<http://www.chinaonline.com/topstories/010403/b101032933.asp>'.

¹⁷⁶ See, e.g., Zhu, Ming & Huang, Jinlao, *supra* note 75, at 7. Some local governments even go to that far to require that a creditor must get the local government's approval before they can file a case against local debtors.

market in China is extremely thin compared to the huge amount of NPLs, and care needs to be taken not to destroy values for the entire banking system through “fire-sale” liquidations.

AMCs in China have to dispose of some NPLs, however, because not all NPLs can be restructured. For example, it was revealed that only 60% of CCB’s NPLs to SOEs met eligibility requirements for debt-equity swaps;¹⁷⁷ some of the NPLs would have to be auctioned or simply written off. Besides, to have AMCs manage the assets for a very long time is costly and takes the risk that asset prices may decline further during this period, particularly if the AMC staff do not have the skills of managing the assets.¹⁷⁸ In Sweden, for example, it was initially thought that its AMC would operate for 15 years but subsequent calculations comparing the holding costs of the assets they held with likely price rises led them to adopt a five-year period instead.¹⁷⁹ It is hard to predict how long the AMCs will have to run in China. It should be clear, however, that AMCs should not warehouse NPLs.

V. DEBT-EQUITY SWAPS

A. DEBT-EQUITY SWAPS: INTERNATIONAL EXPERIENCES

Debt-equity-swaps have been used worldwide to tackle bad debt problems. Examples include the debt-equity swaps in 1980s to workout the lesser-developed-countries’ debts,¹⁸⁰ Russian “loans for shares” deals in 1996,¹⁸¹ and the recent practices in East Asian countries.¹⁸² This

See Chinaonline, ‘Asset Management Firms Struggling to Recoup Debts’ (April 19, 2001), available at ‘<http://www.chinaonline.com/topstories/010419/1/c01041105.asp>’.

¹⁷⁷ See Chinaonline, ‘China Cinda Asset Mgmt to Take Only 60% of CCB’s Debt’ (November 4, 1999), available at ‘<http://www.chinaonline.com/topstories/B2-99110402.asp>’. Of the CCB’s RMB250bn NPLs to SOEs, only RMB140bn, or 60% is owed by SOEs that qualify for debt-equity swaps. *Id.*

¹⁷⁸ See Hawkins, John & Turner Philip, *supra* note 33.

¹⁷⁹ *Id.*

¹⁸⁰ For a detailed description of the Latin American LDC’s debt/equity swaps, see Hilton, Andrew, *Debt/Equity Swaps: Costs, Benefits and Prospects* (1988). Countries involved include Chile, Mexico, the Philippines, Argentina, Brazil, Ecuador, Venezuela, Uruguay, Jamaica, etc.

¹⁸¹ Under this scheme, commercial banks offered to provide the government loans in exchange for managing the state’s remaining shares in selected large enterprises, which, if the government did not repay the loan, would be transferred to the banks. See European Bank For Reconstruction and Development, *Transition Report 1998: Financial Sector in Transition*, note 4 of Chapter 1 at 4 (1998).

¹⁸² See, e.g., Bardache, ‘Thai Oil: Debt Plan Wins Approval’, *Fin. Times* (August 25, 1999); Barnes, William, ‘Thai Oil: Creditors Agree \$2.2bn Debt Deal’, *Fin. Times* (October 23, 1999); Barnes, William, ‘German Lender Swaps Debt for TelecomAsia Stake’, *Fin. Times* (October 2, 1999); Asia Pulse, ‘Indonesia to Save Auto Maker through Debt/Equity Swap’ (November 10, 1999), available at ‘1999 WL 27967423’; and also Business Asia, ‘South Korea: Faltering Financials’ (April 5, 1999), available at ‘1999 WL 10768537’.

type of scheme typically allows a bank to take a free equity stake in a company while forgiving part of its debt.

B. THE DEVELOPMENT OF DEBT-EQUITY SWAPS IN CHINA

Debt-equity swaps were used in China occasionally in the 1980s. Between 1984 and 1988, loans valued at RMB66bn were converted into State investment in enterprises.¹⁸³ Although debt-equity swaps were proposed as early as the mid-1990s as a solution to the bank NPL problem,¹⁸⁴ it was not until 1999, with the establishment of the four AMCs, that debt-equity swaps started being carried out on large scale.¹⁸⁵ The State Economic and Trade Commission (SETC) announced the initiation of the debt-equity swap scheme on August 3, 1999. On November 10, 2000, the State Council promulgated Regulations on Financial Asset-Management Companies. The AMC Regulations confirmed the debt-equity swap scheme initiated by the SETC¹⁸⁶ and authorize the SETC to organize, guide, and to coordinate the swaps.¹⁸⁷

1. The SETC Debt-Equity Swap Scheme

Under the SETC's debt-equity swap scheme¹⁸⁸ —

Only the Four AMCs and SDB Can Conduct Debt-Equity Swaps with SOEs. The four AMCs, together with the SDB, forgive debts owed by SOEs to them in exchange for equity stakes in the enterprises. The equity holding of an AMC is not limited by its net asset value or registered capital.¹⁸⁹

Only Debts Initially Borrowed by 1997 Can Be Swapped.

¹⁸³ See, e.g., A Ming, 'State-Owned Enterprises: How to Confront the Debt Ratio?', *Jingrong Shibao* (Beijing), 1 (October 7, 1995).

¹⁸⁴ See, e.g., Policy Study Office of the PBOC, *Issues on Bank and Enterprise Debt Restructuring*, 35-54, 82-4 (Beijing 1995).

¹⁸⁵ See generally World News Connection, Article by ZXS reporter Tao Guangxiong: 'Focus of State-Owned Enterprise Reform: Converting Debts into Shares Helps Ease Difficulties in State-Owned Enterprise Reform' (September 18, 1999), available at '1999 WL26443497'.

¹⁸⁶ AMC Regulations, *supra* note 91, arts. 16-23.

¹⁸⁷ *Id.* art. 23.

¹⁸⁸ See, e.g., Li, Xia, *supra* note 153.

¹⁸⁹ AMC Regulations, *supra* note 91, art. 16.

Enterprises Must Satisfy Several Conditions before Their Debts Can Be Converted into Equity. First of all, enterprises that can be chosen for the SETC scheme should be: (1) Industrial SOEs established during the period of the "Seventh-Plan" (1986-1990) or the "Eighth-Plan" (1991-1995), or during the first two years of the "Ninth-Plan" (1996-1997). The construction of the enterprises must have been mainly financed by loans from banks in domestic or foreign currencies. And as a result, the enterprises become loss making and have difficulties in repaying loan principal and interest. Or, (2) Industrial enterprises among the 512 key enterprises that become excessively leveraged and consequently loss making because of expansion. The debtor must be an independent legal person. Trading enterprises can only be exceptionally chosen for this pilot trial.

Second, candidate enterprises must have the potential to return to balance after the swaps. Detailed criteria are set to judge this potential — the enterprises must have readily marketable products, advanced and environmentally-friendly technology and equipment, good management (judged on the capacity of the enterprise managers, the financial and accounting system of the enterprises, and the legal documentation of contract relationships of which the enterprises are parties); and, most importantly, the enterprises must have a plan to restructure its operations in line with the modern enterprise system, with the purpose of improving efficiency, and with the redundancy plan approved by local government.

2. The Implementation of the Scheme

To implement the scheme, the SETC sent working groups to various localities to work out a list of candidate enterprises based on industries and quotas.¹⁹⁰ According to Sheng, Huaren, the SETC director, among China's 16,000 large and medium-sized SOEs, over 2,000 had applied for debt-equity swaps, and the SETC recommended 601 SOEs for swaps.¹⁹¹

A debt-equity swap leading group was established to oversee the implementation of the scheme, comprising representatives from the SETC, the PBOC, the MOF and other relevant government agencies. All debt-equity swap agreements are subject to the approval of the leading group. As of June 2000, the leading group had already approved nearly 70 of the

¹⁹⁰ See, e.g., Xinhua News Agency, "'Converting Debts into Shares', An Important Form of SOE Reform" (September 3, 1999), available at '1999 WL 7397282'.

agreements reached between AMC's and recommended SOEs.¹⁹² This practice was later confirmed by the State Council AMC Regulations.¹⁹³

The first debt-equity swap deal was signed on September 2, 1999 between Cinda and Beijing Building Material Group.¹⁹⁴ In September 1999 only, Cinda signed five deals — Beijing Cement Plant deal, Shanghai Jiaohua Plant deal, Meishan (Group) Co. deal, Jiangxi Guixi Fertilizer Plant deal, and a deal concerning a firm in Xinjiang that produces reeds.¹⁹⁵ The other three AMC's joined the scheme after their establishment. In addition to the four AMC's, the SDB has also participated in debt-equity swaps.¹⁹⁶ By the end of 2000, debt-equity swaps worth RMB395.1bn (US\$47.72bn) were completed by 569 SOEs, with the debt-to-asset ratio of these SOEs decreased from more than 70% to below 50%.¹⁹⁷ Most of the deals involve more than one AMC, with the biggest creditor playing a leading role.¹⁹⁸

C. POLICIES BEHIND THE SETC DEBT-EQUITY SWAP SCHEME

1. The Debt-Equity Swap Scheme as Part of the Government Anti-deflation Policies

¹⁹¹ See Chinaonline, 'China Denies Debt-Equity Swaps Just "Word Games"' (February 7, 2000), available at <http://www.chinaonline.com/topstories/000207/2/C00012604.asp>.

¹⁹² See, e.g., Chinaonline, 'Asset-management Firms Continue Restructuring Money-losing State-owned Enterprises' (June 28, 2000), available at <http://www.chinaonline.com/topstories/000628/1/b200062612%20.asp>.

¹⁹³ AMC Regulations, *supra* note 91, paragraph 2, art. 18, which reads as follows:

The debt-equity swap plan and agreement shall be subject to the examination of the SETC, the Ministry of Finance and the PBOC, and be implemented at the approval of the State Council.

¹⁹⁴ See, e.g., Asia Pulse, 'Chinese Firms Sign Country's First Debt-to Equity Deal' (September 3, 1999), available at '1999 WL 18772310'. In June 2000, Beijing Cement Plant was transformed into a limited liability corporation, with registered capital of RMB9630m (Cinda: 71.4%; Beijing Building Material Group: 28.6%). See, e.g., Pan, Yanxi, 'Beijing Cement Limited Liability Corporation Established after Debt-Equity Swap [*quanguo shuojia zhaizhuanggu gongshi zai jing chengli*]', *People's Daily (Overseas Edition)*, 1 (June 29, 2000).

¹⁹⁵ See, e.g., O'Neill, Mark, 'Foreign Bankers Remain Skeptical as Cinda Takes Equity in Five Companies Debt-swap Deals to Test Reform Plan', *South China Morning Post*, 2 (October 14, 1999).

¹⁹⁶ It was reported that the SDB has already made an agreement with the State Investment Management Co. to convert RMB100bn worth of debt to equity. The first two enterprises to use these RMB100bn quotas are China Petroleum Corp. and China National Petroleum Corp.. RMB30bn of their debts are swapped into equity held by the State Investment Management Co. See, e.g., Chinaonline, 'CNPC, Sinopec to Swap US\$3.6bn in Debt for Equity' (October 27, 1999), available at <http://www.chinaonline.com/topstories/c9102605.asp>.

¹⁹⁷ See Chinaonline, 'PBOC: Financial Adjustment and Control Targets Achieved in '00' (January 19, 2001), available at <http://www.chinaonline.com/topstories/010119/1/B201011605.asp>.

¹⁹⁸ See, e.g., Dow Jones International News, 'China Asset Management Companies, Devt Bk Sign First Joint Debt Deal' (October 29, 1999).

China has been facing deflation for years.¹⁹⁹ The debt-equity swap scheme is in fact part of the government anti-deflation policies. There have been complaints that banks are avoiding giving out loans because of rising NPL levels.²⁰⁰ Two reasons can be identified for this “credit crunch”: On the enterprise side, the creditworthiness of enterprises is deteriorating sharply due to the deflation. On the bank side, the banks’ ability to provide credits is greatly limited because of the huge amount of NPLs accumulated on their books. Debt-equity swaps tackle the two sides simultaneously. Banks’ ability to lend will be enhanced when their NPLs are taken over by AMC, while the creditworthiness of enterprises will be enhanced when their capital structure is improved after debt-equity swaps.²⁰¹

2. The Micro-economic Effects: a Win-Win Situation for SOEs and Banks

Some economists in China note that debt-equity swaps will lead to a “win-win” situation for banks and SOEs, as the swaps help SOEs solve the problem of a heavy debt burden and help banks avoid financial risks simultaneously.²⁰²

The debt-equity swap can relieve the burden on many Chinese SOEs struggling under the weight of loan payments, allowing them to direct their resources on efforts to modernize and restructure. Beijing Cement Plant is a good example of this. After the transaction, the company’s debt-asset ratio fell from 80.5% to 31.7%. The restructured company is expected to turn its loss into profit and earn profits up to RMB15m from 2000 on.²⁰³ A more general example is the 42 enterprises recommended by the SETC to the Huarong AMC for debt-equity swaps. It was calculated that the swaps would reduce these companies’ annual interest payments by a total of RMB1.78bn, a figure that exceeded their aggregate book loss in 1998

¹⁹⁹ See Wu Jinglian, ‘The Macroeconomic Trend in 1999 and Policy Options’ in *Strengthening the Banking System in China: Issues and Experience*, BIS Policy Papers No. 7, 116, at 116-7 (October 1999).

²⁰⁰ These complaints were dismissed by the PBOC, though. See Xinhua English Newswire, ‘China’s Bank Loans on Target’ (April 5, 1999), available at ‘1999 WL 7931582’.

²⁰¹ See Wu, Youchang & Zhao, Xiao, ‘Debt-to-Equity Swap: A Theoretical and Policy Analysis Based on Corporate Governance [zhaozhuang: jiyu qiye zhili jiegou de lilun yu zhenche fengxi]’, *Economic Research Journal (jingji yanjiu)* No. 2, 26, at 30 (Feb. 2000).

²⁰² See, e.g., CBNet, ‘China: Debt-to-equity Swaps: A “Win-Win” Choice for Banks and Firms’ (October 20, 1999), available at ‘1999 WL 17731561’.

²⁰³ See, e.g., Pan, Yanxi, *supra* note 194.

of RMB1.04bn. Within a year of the swaps, the 42 SOEs are expected to report combined profits of RMB740m.²⁰⁴

More importantly, the debt-equity swap could also diversify the ownership of SOEs²⁰⁵ and improve their corporate governance. After the swaps, the SOEs will have to give board representation to AMCs and tailor business decisions to meet investor demands.

Therefore, in the short term, converting debts into shares will help China attain the goal of freeing its SOEs from difficulties in three years;²⁰⁶ and in the long run, converting debts into shares will serve as a booster enabling SOEs to establish a modern enterprise system. The achievement of these goals, however, depends on AMCs' capacity to run industrial businesses, and whether the restructured companies can find strategic investors²⁰⁷ who become involved in the management of the firms and place them under pressures to become profitable.²⁰⁸

Because the swaps are carried out by AMCs rather than the State commercial banks, the swaps will not have direct impact on banks' balance sheets.²⁰⁹ However, the improvement

²⁰⁴ See Chinaonline, 'China Huarong to Relieve ICBC of Bad Loans Worth US\$42.3bn' (December 3, 1999), available at '<http://www.chinaonline.com/topstories/991203/B9120238.asp>'.

²⁰⁵ In Shanghai, for example, dozens of SOEs plan to swap debts totaling RMB 20-30bn into equity by the end of 1999. That is estimated to decrease the proportion of state shares in these enterprises from 65% to 50%. See Chinaonline, 'Dozens of Shanghai SOEs Plan Debt-for-Equity Swaps' (October 4, 1999), available at '<http://www.chinaonline.com/topstories/C9092909.asp>'.

²⁰⁶ The three-year goal was pledged by Zhu Rongji in early 1998 when he was appointed China's Premier. This goal was reiterated at the 4th Plenum of the 15th Central Committee of the CCP held in September 1999. See, e.g., Chinaonline, 'China Reiterates Goal to Make SOEs Profitable in Three Years' (September 24, 1999), available at '<http://www.chinaonline.com/topstories/C9092211.asp>'.

By the end of 1997, a total of 6,599 medium- to large-size SOEs were in red. The government's goal is to reduce the number of companies in debt by one third in three years by push them into mergers, bankruptcy, reorganization, regrouping and management restructuring. See, e.g., Chinaonline, 'China SOEs Must Turnaround By Next Year- Official' (November 24, 1999), available at '<http://www.chinaonline.com/topstories/991124/b9112320.asp>'.

There were reports that the three-year reform goals for SOEs had been successfully achieved by the end of 2000. See Chinaonline, 'Three-year Goals for SOE Reform and Relief Mostly Realized' (January 2, 2001), available at '<http://www.chinaonline.com/topstories/010102/C00122803.asp>'.

²⁰⁷ In China, a strategic investor is defined as a legal person closely associated with the issuing firm and intending to hold issued stocks for a long term. Circular on Improving Stock Issuance, issued by the CSRC in October 1999.

²⁰⁸ According to Zhang, Chunlin, a delegate for the World Bank in Beijing, investors who purchased state firms might face difficulties in freeing the companies from the control of local governments, making it difficult to return companies to profit. Thus, if the AMC cannot resist the interference from government, it will not make sense whether it holds shares or debts in the company. See, e.g., AFX (AP), 'Interview' (September 6, 1999), available at '1999 WL 25400825'.

²⁰⁹ Many Chinese scholars ignore the fact that AMCs are legally independent from the banks by arguing that debt-equity swaps reduce the NPL level of banks. See, e.g., Zhou, Tianyong, 'The Transfer Mechanism of Debt-to-Equity Swap Programme and the Operation Risk [zhaizhuanggu de liucheng jili yu yunxing fengxian]', *Jingji Yanjiu (Economic Research Journal)* No. 1, 22, at 22 (January 2000).

in SOE profitability will certainly increase the enterprises' capacity in repaying loan principle and interest and thus help improve banks' profitability and avoid potential financial risks.

3. Justification for Converting SOEs' Debts into Equity

There are arguments against the current debt-equity swaps on the basis that the scheme gives SOEs unfair market advantages by releasing their debt burden.²¹⁰ These authors, however, forgot to investigate how SOEs have developed high debt-asset ratios.²¹¹

It is a common practice that owners provide their firms with sufficient capital. This rule, however, was not obeyed by the Chinese government, the owner of SOEs. Starting in 1980, working capital was partially provided in the form of bank loans.²¹² In July 1983, a circular was issued by the State Council to put all SOEs' working capital under the management of the banks, with different interest rates charged on working capital loans according to their terms.²¹³ With regard to the financing of fixed-asset investment, a pilot trial started in 1979 to issue loans for fixed-asset investments.²¹⁴ In 1984, budget financing for fixed-asset investment was completely replaced by fixed-asset loans.²¹⁵ It was not until 1996 that minimum capital requirements were set for fixed-asset investment.²¹⁶ In other words, the government, as the owner of SOEs, had stopped providing SOEs with sufficient capital for a period of time. That explains to some extent why SOEs in China have such high leverage

²¹⁰ See, e.g., Chinaonline, *supra* note 106.

²¹¹ The discussion in the paragraph and the following paragraphs draws heavily from Wu, Xiaolin & Xie, Pin, 'Some Ideas about SOE's Debt Restructuring' in Policy Study Office of PBOC, *Issues on Bank and Enterprise Debt Restructuring*, 2-3 (Beijing 1995). Ms. Wu and Mr. Xie were the heads of the PBOC Policy Study Office when they wrote the cited paper.

²¹² See Policy Study Office of PBOC, *supra* note 184, at 104.

²¹³ Circular of the State Council Approving and Promulgating the Report of the People's Bank of China on PBOC's Unified-Management of State-Operated Enterprises' Working Capital, issued by the State Council on June 25, 1983.

²¹⁴ See Policy Study Office of PBOC, *supra* note 184, at 104. By the end of 1980, 619 loan contracts had been signed for fixed-asset investments. *Id.*

²¹⁵ Interim Provisions Converting All State Budgetary Capital Construction Investment from Appropriations to Loans, adopted by the MOF on December 14, 1984. The budget financing for fixed-asset investment started again in 1985 when the budget financed 10 construction projects. From 1988 on, a Central Basic Construction Fund was established to finance state construction projects. See Policy Study Office of PBOC, *supra* note 184, at 104.

²¹⁶ Circular of the State Council on Implementing on a Trial Basis the System of Capital Funds in Projects which Involve Investment in Fixed Assets [guowuyuan guanyu shixing guding zichan touzi xiangmu shixing zibenjin zhidu de tongzhi], issued on August 23, 1996. The Chinese Version of the Circular is available at State Council Gazette [guowuyuan gongbao], No. 27, 1074-1077 (September 27, 1996). The Circular requires that

ratios.²¹⁷ Anecdotal evidence supports this assertion as well. Beijing Cement Plant, the first SOE selected for the debt-equity swap, was built between March 1993 and mid-1995. The initial budget was RMB393m. Due to a sharp rise in the cost of steel and cement, however, the final cost reached RMB818m and the balance was totally financed by CCB loans.²¹⁸

To conclude, SOEs should not be blamed solely for their high debt-asset ratios. And the government should at least to some extent bear the responsibility for that. Debt-equity swaps at least can give some SOEs an opportunity to restart.²¹⁹

D. PROBLEMS WITH THE CURRENT DEBT-EQUITY SWAP SCHEME AND RECOMMENDED SOLUTIONS

1. Moral Hazard Problem

Moral hazards are the biggest risks that need to be guarded against in the implementation of the debt-equity swap scheme. There are moral hazards of debtor enterprises and of local governments.²²⁰

Debt-equity swaps are *de facto* a gambling between the central government/AMCs and local governments/debtor enterprises. The central government and AMCs want to mitigate financial risks via debt-equity swaps and recover as much as possible when the financial situation of their debtors improves. The debtor enterprises and local governments, however, aim at releasing themselves of the debt burdens by debt-equity swaps and paying as little dividend as possible to AMCs.

Theoretically, SOEs in China fall into three categories: Enterprises in the first category are those who can pay their debts on time. Enterprises in the third category are those who have no potential to return to profit. Enterprises between them, *i.e.*, those who have

the owner of a fixed-investment project must have invested a certain amount (varies for projects in different industrial lines and regions) of capital funds.

²¹⁷ See Chinaonline, *supra* note 106.

²¹⁸ See South China Morning Post, 'Cement Plant Finds Life After Debt-Equity Swap' (October 25, 1999).

²¹⁹ Compared to closure & liquidation, or keeping the enterprise floating without tacking their extensive debt-asset ratio, debt-equity swaps might be an optimal option. Closure and liquidation cannot be applied ubiquitously, given the important role SOEs play in the economy. Second, if the enterprise debt-asset ratio remains at unreasonably high level, most of the SOEs will not have chance to return to profit. Moreover, there will be moral hazard problem with over-leveraged enterprises. See Wu, Youchang & Zhao, Xiao, *supra* note 201, at 30.

²²⁰ The discussion in the section draws heavily from Zhou, Tianyong, *supra* note 209, at 22.

difficulties in paying bank loan principal and interest because of their irrational capital structure fall into the second category. If the criteria set by the SETC can be strictly applied, debt-equity swaps should only be applied to the second-category-enterprises.

The real picture is much more complicated, however. There are disincentives for enterprises of the first category. Because they are in better financial condition, they are not qualified for debt-equity swaps and thus have to pay their debts in full; while those enterprises who are not doing as well as them can enjoy the debt forgiveness (although they will have to pay dividends to AMC's later, the payment of dividends are not compulsory). Enterprises of the first category therefore may choose to "downgrade" themselves to qualify for debt-equity swaps. In other words, they have incentives not to work as hard as before. Enterprises in the third category will have incentives to "qualify" themselves for debt equity swaps by polishing their accounting reports and providing incorrect information about their potential in returning to profit. The enterprises in the second category, while they are qualified for debt-equity swaps, might have the expectation to be bailed out by the government in the future and lack incentives to improve their management and operations after their debt burdens are mitigated. Making matters worse, enterprises are often countenanced or even helped by local governments to "qualify" for the scheme. In this way, local governments are competing for resources. It is therefore no wonder that more than 500 SOEs with assets of RMB358.5bn applied to the SETC to join the scheme in a month after the scheme was initiated.²²¹

The problem was so serious that Shen Huaren, the SETC director, stated at the Working Conference of State Economy and Trade in Beijing in later November 1999 that "[d]ebt-for-equity swaps should be conducted within a proposed name list recommended by the SETC", "[a]ny unauthorized swap is not permitted."²²² To prevent local governments from imposing their enterprises on AMC's for the scheme, Mr. Shen warned that if fraud were discovered, such deals would be canceled "and debt-for-equity swaps for enterprises in the entire province will be suspended."²²³ The announcement had a retrospective effect.²²⁴ The

²²¹ These enterprises had an average debt-asset ratio of 80.3%, and RMB188.2bn in long-term liability. See World News Connection, *supra* note 185.

²²² See Chinaonline, 'Unauthorized Debt-equity Swaps Are Void- Beijing' (November 23, 1999), available at '<http://www.chinaonline.com/topstories/991123/b9112231.asp>'.

²²³ *Id.*

²²⁴ According to Mr. Shen, Those debt-equity swap deals unauthorized by the SETC "already completed are considered no longer effective, otherwise no new programs will be approved". *Id.*

AMC Regulations promulgated by the State Council in November 2000 confirmed that AMCs could only conduct debt-equity swaps with enterprises recommended by the SETC.²²⁵

The strict restriction on candidate enterprises can surely to some extent solve the moral hazard problem. There are other concerns, however. First, whether the SETC can carry out the criteria completely remains doubtful. Because of the information asymmetry between the SETC and the local governments (and enterprises), the SETC has to rely on information provided by enterprises and local governments to make the selection. And, because the SETC does not bear the cost and responsibilities for debt-equity swaps, they have all the reasons to bend to pressures from local governments and enterprises.²²⁶ Second, because all the transactions are subject to the approval of the SETC, there are disincentives on AMCs. Since the final decisions are not made by AMCs but by the SETC, AMCs will have an excuse when a deal proves unsuccessful later on.

In selecting candidate enterprises, the author here would suggest that AMCs be granted discretion not to carry out debt-equity swaps with recommended enterprises so that they can double check the financial situation and potential of the enterprises.

2. Lack of Workable Reorganization Plan

The success of the debt-equity swap scheme cannot be taken for granted. If the enterprise cannot be effectively restructured, if the enterprise governance structure cannot be improved,²²⁷ the debt-equity swaps by no means can really return SOEs to profits and reduce

²²⁵ AMC Regulations, *supra* note 91, art. 18, which reads as follows:

The State Economic and Trade Commission shall recommend enterprises to AMCs for debt-equity swaps. The AMCs shall conduct independent evaluation and examination of the recommended enterprises, draft plans for the debt-equity swaps and sign swap agreements with the enterprises.

²²⁶ *E.g.*, at least one of the announced deals signed by Cinda — with a Xinjiang company that is the largest reed producer in the mainland's northwest — raises concerns. That company is part of the military-owned Construction and Engineering Group (Bingtuan), one of the biggest industrial and agricultural entities in the border region. The deal appears to flaunt the SETC swap guidelines because reed cannot be considered a priority product. There is suspicion that Cinda was forced into the deal by the political lobbying power of the Bingtuan and Beijing's preferential policies for border regions, which are less developed than the east coast. See O'Neill, Mark, *supra* note 195.

²²⁷ Although high leverage ratios contribute to SOEs' low profitability. It is the management capacity of enterprise manager, the product marketability that really decides the profitability of an enterprise. See, *e.g.*, Yuan, Gangming, 'Empirical Analyses on China SOEs' Bad Debts [zhongguo guoyu qiye buliang fuzhai de shizheng fengxi], *Economic Research Journal* No. 12, 12, at 17 (2000).

financial risks²²⁸ — the increase in enterprise book profits by reducing interest payments remains a paper game.²²⁹ It is therefore essential that a workable reorganization plan can be agreed and enforced in debt-equity swap transactions.²³⁰

China's AMC's concluded debt-equity swap agreements with SOEs recommended by the SETC in a hurry, mainly because of the SETC requirement that framework agreements for debt-equity swaps should be research by mid 2000.²³¹ On December 28, 1999 only, for example, the nation's four AMC's signed agreements with ten SOEs to swap RMB4.13bn of their aggregate debt.²³² That made debt-equity swaps look like debt amnesty in China.²³³

It seems that emphasis has mainly been put on improving enterprises' book profits by reducing their interest expenditures, rather than on improving their real profit-earning capability in most of the reported deals.²³⁴ Except in a few cases, most of the reported deals do not include substantial reorganization plans. Presumably, this is because most of the agreements so far reached are only framework agreements and need to be detailed by further negotiation.

The current author, however, doubts whether there can be substantial reorganization plans later on. First, the governments at various levels are reluctant in pushing rigorous reorganization plans. Even the SETC itself provides that enterprises involved in debt-equity swaps are not permitted to merge or declare bankruptcy.²³⁵ The local governments, concerned about the local welfare, are not willing to support reorganization plans including large layoffs.²³⁶ And they are in the right position to kill such kinds of reorganization plans.²³⁷

²²⁸ If the profitability of the enterprise sector has not been improved, then although the banks are released of the NPLs, the government will have to bail out the AMC's eventually. Moreover, new loans to the enterprise sector will become NPLs again and new financial risks will be accumulated in the banking sector. See Wu, Youchang & Zhao, Xiao, *supra* note 201, at 30.

²²⁹ *Id.*, at 29.

²³⁰ It is required that after the debt-equity swap, enterprise transform their operational mechanism, establish a standardized corporate governance system according to the requirement of the modern enterprise system; and that local government assist enterprise in cutting payroll, increasing returns, diverting the laid-off workers, and freeing the enterprise from extra social responsibilities. AMC Regulations, *supra* note 91, art. 19.

²³¹ See Chinaonline, *supra* note 150. The existence of a deadline was very important as to spur AMC's to finish the process so that NPLs will not stay with them too long.

²³² See Chinaonline, 'Ten SOEs Signed Debt-to-equity Swaps in China' (December 30, 1999), available at '<http://www.chinaonline.com/industry/financial/currentnews/secure/C9122903c.asp>'.

²³³ See Chinaonline, 'Debt-Equity Can Mean Debt Amnesty in China, Expert' (January 6, 2000), available at '<http://www.chinaonline.com/topstories/000106/C00010630b.asp>'.

²³⁴ See Dow Jones International News, 'China Govt Paper Warns of Moral Risk in Debt-Equity Plan' (December 6, 1999).

²³⁵ See Chinaonline, *supra* note 222.

²³⁶ See Chinaonline, *supra* note 150.

Second, the AMCs do not have sufficient incentives and expertise to impose reorganization plans on SOEs. In many cases, AMCs only hold a minority stake and cannot carry out their influences efficiently. Besides, most deals bear a purchase-back provision, under which the parent company of the enterprise promise to purchase back equity held by AMCs during a certain period of time,²³⁸ creating disincentives for AMCs to act positively in improving SOEs' profitability and operation. Moreover, even if AMCs are willing and allowed to make the intervention, whether they have the capacity of doing so is another problem.²³⁹

There are suggestions that compulsory dividend distribution be provided in debt-equity swap agreements so that AMCs and their debtor enterprises will have incentives to improve enterprises' management and operation.²⁴⁰ The current author, however, would argue that attention should be paid to include outsider investors in the debt-equity swap, breaking the circle among banks, AMCs and enterprises. Only if AMCs have transferred parts of the equity they acquired from the swaps to outside investors, can the corporate governance of the enterprises be improved.

E. AMCS' EXIT PROBLEM

1. The Importance of AMCs' Timely Exit

AMCs are not NPL warehouses. They should only hold equity converted from debts temporarily.²⁴¹ The exit of AMCs is essential to the success of debt-equity swap scheme.

First, to the enterprise managers, debt constraints are harder than that of equity.²⁴² With regard to SOEs in China, although debt constraints are not really hard budget

²³⁷ See Li, Xia, *supra* note 153. According to the SETC guidelines, a restructuring plan involving large layoffs must be approved by the relevant local government. *Id.*

²³⁸ E.g., in the Beijing Cement Plant deal, Beijing Building Material Group has the rights to purchase back the shares held by Cinda in three years after the deal. See Li, Xia & Wang, Xing, 'Debt-Equity Swap Started in China [zhanzhuanggu jingru shizixing chaozhou]', *Jingrong Shibao*, 12 (September 15, 1999). The same provisions can also be found in the Metallurgy Group Co. (Ye Gang) deal. See Chinaonline, 'Xinda Asset Mgmt Lightens China Yegang Steel's Debt Load' (November 11, 1999), available at '<http://www.chinaonline.com/topstories/991111/c9111003.asp>'.

²³⁹ See, e.g., Wu, Youchang & Zhao, Xiao, *supra* note 201, at 31.

²⁴⁰ See, e.g., Zhou, Tianyong, *supra* note 209, at 27.

²⁴¹ See, e.g., Zhu, Ming & Huang, Jinlao, *supra* note 75, at 8.

²⁴² See, e.g., Wu, Youchang & Zhao, Xiao, *supra* note 201, at 31.

constraints, compared to the owner of the SOEs — the State represented by various government agencies, banks as creditors are putting more constraints on enterprise borrowers. The debt-equity swaps actually remove the constraints from SOEs.²⁴³ Second, as mentioned before, the AMC's lack the incentives and capacity to restructure enterprises and monitor their operations. It is therefore important for AMC's to dispose of the equity they acquired in a timely manner to those capable domestic or overseas investors.

Moreover, at the end of the day, AMC's must cashout banks in return for the NPLs (which they currently have paid in bonds). If AMC's can neither receive dividends from SOEs nor cash in the equity they acquired via the swaps, they will have no resources to pay the banks. Consequently, banks will have no way to repay depositors, and the government will ultimately have to take responsibility for repayment.²⁴⁴

2. Probable Exit Routes for AMC's and Obstacles

The government's idea behind the debt-equity swap scheme is that by converting their debts into equity, those SOEs, particularly enterprises in highly competitive industries, can be gradually introduced to private investors, making them truly public companies. In this way the AMC's can dispose of their shareholdings to the public.²⁴⁵ There are other possible exits as well, such as selling equities privately to domestic or foreign investors or selling the equities back to the enterprise.²⁴⁶ All these exist routes are provided in the State Council AMC Regulations.²⁴⁷ Whether AMC's can exit through these routes, however, remains doubtful.

(i) *Difficulties in Disposing Shareholdings by Selling Them to the Public*

To list the enterprises and sell shares to the public is considered the optimal route for AMC's to dispose of the shares they acquired via the swaps. There are at least three obstacles, however.

²⁴³ *Id.*, at 32.

²⁴⁴ See AFX, 'China Debt Disposal Via AMC's Seen "Worse than Imaginable"' (December 8, 1999), available at '1999 WL 25421659'.

²⁴⁵ See, e.g., Chinaonline, *supra* note 106.

²⁴⁶ See Liu, Min, 'The Operation of "Debt-equity Swaps": the Exit of AMC's [zhaizhuanggu shishi ji tuichu fangshi chutuan]', *Jingrong Shibao*, 12 (September 15, 1999).

²⁴⁷ AMC Regulations, *supra* note 91, art. 21.

One is the listing criteria, including rules that require firms to have three consecutive years of profits before they can sell shares to the public.²⁴⁸ That means it will at least take three years after the swap before the company can be listed because only loss-making SOEs are qualified for the swap scheme.

Second, although there are now pilot trials to dispose of State shares in joint stock companies, State-owned shares, including those held by State-owned units,²⁴⁹ are not allowed to circulate freely in the stock exchange.²⁵⁰ If this rule cannot be changed, the shares held by AMCs, that are all wholly State-owned, will not be tradable in the stock exchanges even if the enterprise succeeded in listing eventually.

Third, even if these two rules can be changed or zigzagged, disposing of shareholdings via stock markets will need a very long period of time. By the end of 2000, debt-equity swaps worth RMB395.1bn (US\$47.72bn) were completed by 569 SOEs,²⁵¹ while at the end of November 2000, the total market value of China's securities market only exceeded RMB4.6 trillion.²⁵² It is obvious that it will take a while for the domestic stock exchanges to digest the equity acquired by AMCs via debt-equity swaps.

Listing abroad might be another choice. But there are problems as well. First, according to the 1994 State Council Special Regulations on Limited Stock Companies Issuing Stock and Listing Abroad, the dividend of a company listed abroad should be declared in RMB but paid in foreign currency in accordance with foreign exchange regulations.²⁵³ The capital account control in China will therefore be an obstacle for SOEs to raise capital in foreign stock exchanges. Second, according to updated requirements and procedures for Chinese enterprises applying for an overseas stock market listing issued by

²⁴⁸ According to the Company Law of the People's Republic of China, a company that wishes to issue new stocks must have earned profits in each of the last three years and is able to pay dividends to its shareholders, the company's anticipated profit rate must at least meet the interest rate on bank deposits, in addition to other conditions. The Company Law of the People's Republic of China, adopted at the fifth Session of the Standing Committee of the Eighth National People's Congress on December 29, 1993 and effective as of July 1, 1994 (as amended in 1999), art. 137.

²⁴⁹ In China, shares issued by a joint stock company have been specially divided into state shares [guojiagu], legal person shares [farengu] (including state-owned legal person shares, collective enterprise legal person shares, institutional legal person shares), individual shares [gerengu] and foreign capital shares [waizigu]. State shares and state-owned legal persons shares are called state-owned shares. See, e.g., Gu, Minkang, 'Acquisition of State-owned Shares through Chinese Securities Markets: A Way of Privatization?', *International Business Lawyer*, 386, at 386 (October 1999).

²⁵⁰ *Id.*

²⁵¹ See Chinaonline, *supra* note 197.

²⁵² See Chinaonline, 'China's Securities Market Valued at US\$556.44B' (December 15, 2000), available at '<http://www.chinaonline.com/topstories/001215/1/B200121318.asp>'.

CSRC in 1999, any Chinese enterprise wishing to list overseas must have net assets of more than RMB400m. The company's after-tax profits from the previous year should be no less than RMB60m. And, calculated according to a reasonably expected price-earning ratio, the financing should be no less than US\$50m.²⁵⁴ Third, there are requirements from the host securities exchange and/or commission as well.²⁵⁵ Last but not least, it seems unlikely that the foreign investors would be willing to invest in firms with uncertain future.²⁵⁶

(ii) *Difficulties in Selling Shares to Strategic Investors*

Another way for the AMCs to dispose of their shareholdings is to sell them to domestic and overseas strategic investors.²⁵⁷ There are already such sales to domestic investors.²⁵⁸

The participation of foreign investment is essential. In view of China's national condition, the State sector is not able to absorb all the NPLs, and the developing private sector lacks the strength for large-scale participation.²⁵⁹ China had had a total of US\$348.62bn in accumulated foreign investment by the end of 2000.²⁶⁰ It remains a question

²⁵³ Special Regulations on Limited Stock Companies Issuing Stock and Listing Abroad, art. 27.

²⁵⁴ See Chinaonline, 'China Updates Overseas Listing Rules' (July 20, 1999), available at 'http://www.chinaonline.com/industry/fina...Archive/Secure/1999/july/fn_c9071916.asp'.

²⁵⁵ E.g., the IPO of China National Petroleum Corporation (CNPC), for example, was held up by extensive scrutiny from the US securities regulator in February 2000. The delay was holding up a number of other Chinese listing hopefuls. See Lin, Ho Swee, 'CNPC: IPO Delayed by US Regulator' *Fin. Times* (February 2, 2000).

²⁵⁶ The IPO of Beijing Capital International Airport in January 2000 served a good example for this assertion. The public portion of the BCIA equity offering on 28 January was under-subscribed and was expected to be priced at the lower end as underwriters struggled to place the paper. According to analysts, this issue is overshadowed by a domination of high-growth stocks. The SOEs are being overshadowed by the technology sector. Because China's State-run companies are perceived to have excessive production capacity, huge workforces, heavy debts, and be loss making, there is a lot of skeptics about any Chinese stock which does not have a clear growth potential. See Lin, Ho Swee & Ostrovsky, Arkady, 'Beijing: Airport IPO Short of Full Take-up', *Fin. Times* (January 28, 2000).

²⁵⁷ It is reported that Cinda offered 38 debt-equity swap projects to foreign investors in September 2000. See, e.g., 'Debt-equity Swaps Are to Be Opened to Overseas Investors [zhaizhuanggu nidui waizi kaifang]', *People's Daily (Overseas Edition)*, 5 (September 16, 2000).

²⁵⁸ E. g., in December 2000, China Huarong AMC sold its entire equity, worth RMB115m, in Xinjiang Shiyue Tractor Manufacturing (Group) Corp. to Xingjiang Guanhui Enterprise (Group) for 105% of the current value. The sale is the first of this kind for the country. See Chinaonline, 'China Huarong Asset Management Turns Liabilities into Assets with Sale' (December 12, 2000), available at '<http://www.chinaonline.com/topstories/001212/1/C00121112.asp>'.

²⁵⁹ See, e.g., Chinaonline, 'Foreign Investors a Useful Tool in Disposing Nonperforming Assets in China, Exec Says' (January 3, 2001), available at '<http://www.chinaonline.com/topstories/010103/1/B100122510.asp>'.

²⁶⁰ See Chinaonline, 'Foreign Investment in China Surpasses US\$40B Last Year' (January 18, 2001), available at '<http://www.chinaonline.com/topstories/010118/1/C01011707.asp>'.

whether foreign investors would be prepared to buy shares in State-run companies, however.²⁶¹

Besides, the sale of State-owned shares in Chinese companies to foreign investors would prove difficult. In 1994, the Administration of State-owned Assets and the State Commission for Economic Restructuring jointly issued the Interim Provisions on the Management of State-owned Shares in Joint Stock Companies. According to the Interim Provisions, holders of State-owned shares intending to transfer State-owned shares to foreign investors should apply to the Administration of State-owned Assets for examination and approval; when the transfer of State-owned shares involves huge amounts or may result in changes in absolute or relative holding rights, the transferor must apply for examination and approval from the Administration of State-Owned Assets, the State Commission for Economic Restructuring and other related government agencies.

(iii) *Difficulties in Selling Back the Shares to the Debtor Companies or Their Parent Institutions*

Purchase-back clauses are not uncommon in debt-equity swap deals in China.²⁶² But this would also require that AMCs hold their shares for a long time, restructure the enterprises, establish a new management system and bring the companies back to profit. Otherwise, the companies cannot afford to buy back the shares. Or even if they managed to buy back the shares, the companies will remain unchanged, self-defeating the purpose of the debt-equity swap.

F. SUMMARY

It is not surprising that debt equity swaps are chosen as the main strategy for AMCs to deal with the NPLs they collected from banks. AMCs in China are not only mandated to improve banks' financial condition, but also to save SOEs. Macro-economically, the debt-equity swap

²⁶¹ There is report, however, that dozens of well-known foreign investment companies have had extensive contacts with Cinda, and both sides have reached substantial agreement on their intention for future cooperation. See Chinaonline, 'China Asset-Management Firms Offer Shares to Foreign Firms' (April 20, 2000), available at '<http://www.chinaonline.com/topstories/000420/2/C00041910.asp>'.

scheme is part of the government's anti-deflation policy. And, for some SOEs, if their excessive debt-asset ratios can be reduced to a reasonable level, they can hopefully grow out of difficulties.

There are problems with the implementation of the scheme, however. First, although criteria have been set by the SETC on what enterprises are qualified for the scheme, it is doubtful whether these criteria can be carried out completely. Second, most of the deals signed so far do not contain substantial enterprise reorganization plans, putting doubts on whether the enterprises will improve their performance after the deal. Third, there are difficulties, both legally and economically, for AMC's to dispose of the equity they acquire via the swaps.

VI. A PROPER LEGAL INFRASTRUCTURE FOR DEBT DISPOSAL AND RESTRUCTURING

Debt disposal and debt restructuring can only be carried out under a proper legal infrastructure. For debt disposal, it is important to have an efficient, rapid and transparent legal process to enforce loan repayment.²⁶² For debt restructuring, a structure in which banks or AMC's can negotiate with their debtors is essential. Actually, these two structures are complementary to each other. For debt restructuring, it is important that there are pressures on debtors to reach debt-restructuring agreements with banks or AMC's. In this sense, the existence of an efficient, rapid and transparent legal process to enforce loan repayment is essential to the success of debt restructuring.

A. CREDITOR PASSIVITY OF THE BANKS IN CHINA: THE LACK OF AN EFFICIENT LOAN COLLECTING MECHANISM IN CHINA

1. The Phenomena

²⁶² *Supra* note 238 and the accompanying text. There was report, however, that enterprises were unwilling to make purchase-back promises. See Chinaonline, *supra* note 150.

²⁶³ See Hawkins, John & Turner Philip, *supra* note 33.

Creditor passivity of the banks denotes that creditors involuntarily or voluntarily tolerate their debtors' default. This term was first used by David Begg and Richard Portes in their 1993 paper on enterprise debt and financial restructuring in Central and Eastern Europe.²⁶⁴

The creditor passivity of the banks is pervasive in China. When enterprise debtors fail to pay loan principal and interest on time, instead of enforcing the loan contract against defaulting debtors, foreclosing the collateral, filing a bankruptcy case as the last resort, or seeking debt-restructuring arrangements, banks often choose to simply reschedule or roll over their loans.²⁶⁵ Although the Enterprise Bankruptcy Law²⁶⁶ has been in effect since November 1, 1988, only a few enterprises have been placed in bankruptcy.²⁶⁷ Furthermore, among all the bankruptcy cases, only a handful of them were initiated by banks. For example, in 1994, among all the bankruptcy cases filed with the court, only 1.7% of them were initiated by banks.²⁶⁸ In 1995, only 47 of the 2,385 bankruptcies were initiated by banks; of the 6,232 bankruptcies in 1996, only 72 were initiated by banks.²⁶⁹ As an adjunct to the banks' reluctance in directing an enterprise into bankruptcy, the banks also become unwilling and sometimes strongly adverse participants in reorganization or compromise proposals.²⁷⁰ Making matters worse, banks are often required by the government to subsidize enterprise reorganization. For example, to encourage acquisitions of weak industrial SOEs by healthy SOEs, banks are required to exempt or suspend the interest repayment of the loans to acquired SOEs.²⁷¹ To assist mergers of large- and medium-sized SOEs, declarations of

²⁶⁴ See generally Begg, David & Portes, Richard, 'Enterprise Debt and Financial Restructuring in Central and Eastern Europe', *European Economic Review* No. 37, 396 (1993).

²⁶⁵ See, e.g., Wang, Wuyi, 'Analyzing Factors Influencing the Bankruptcies of China's State-Owned Enterprises', *Jingji Yanjiu (Beijing)*, 41 (June 20, 1994).

²⁶⁶ The Law of Bankruptcy for Enterprises of the People's Republic of China (Trial Implementation), adopted by the 18th Session of the 6th NPC on December 2, 1986 and effective as of November 1, 1998 (hereinafter referred to as "the Enterprise Bankruptcy Law"). This law applies only to SOEs. For an English translation, see Boshkoff, Douglas G. & Song, Yongxin, 'China's New Bankruptcy Law: A Translation and Brief Introduction', 61 *Am. Bankr. L. J.* 359 (Fall, 1987).

²⁶⁷ According to unofficial statistics, Chinese court had only accepted over 11,600 bankruptcy cases from the effectiveness of the Enterprise Bankruptcy Law to mid-1997. Among them, the majority were non-SOE enterprise bankruptcies. Furthermore, of those bankrupted SOE's the majority are small enterprises with fewer than 1,000 employees. See generally Miller, Sheryl, 'Institutional Impediments to the Enforcement of China's Bankruptcy Laws', 8 *Int'l Legal Persp.* 187.

²⁶⁸ See, e.g., Pan, Yue (ed.), *Policies and Procedures for Asset Restructuring*, 209-10 (Beijing: 1997).

²⁶⁹ See Macartney, Jane, 'China Sharply Accelerates Bankruptcies in 1996', *Reuter News Service* (January 28, 1997).

²⁷⁰ See, e.g., Harmer, Ronald Winston, 'Insolvency Law and Reform in the People's Republic of China', 64 *Fordham L. Rev.* 2563 (May, 1996).

²⁷¹ Circular on How to Deal with Bank Loan Principal and Interest to Weak Industrial SOEs in 18 Pilot Cities when They Are Acquired by Healthy SOEs, issued by PBOC, SETC, and MOF on May 4, 1995.

bankruptcy, and the closure or resource-drained mines, State commercial banks wrote off bad debts worth RMB117.6bn (US\$14.23m) from 1998 to 2000.²⁷²

2. The Causes

Janet Mitchell discusses causes of “creditor’s passivity” using Hungarian experiences.²⁷³ First, banks may not initiate bankruptcy proceedings because the expected value of the debtor’s assets are less than the costs of enforcing bankruptcy, or because there is an option value in waiting. In the former case, there is no incentive for new lending, whereas the latter may justify rescheduling debt; a sufficiently favorable outcome may work wonders for existing NPLs. Second, taking action against debtors may signal the extent of the bank’s NPLs. Third, there may be free rider problems when there are multiple creditors. If each bank foresees that a government bailout will become necessary because other creditors take no action, such an expectation may become self-fulfilling.

In China, in addition to these normal causes, several factors can be identified as causes of banks’ passivity in collecting loans. There are disincentive factors within and outside the banking regime. The disincentive factors outside the banking system include the reluctance of the government to allow insolvent SOEs’ to file bankruptcy, weakness in the court system, the lack of an adequate social welfare, local protectionism, the short history of bankruptcy law in PRC, and so on.²⁷⁴ A PBOC survey found problems such as bankruptcy practices not being standardized, the erosion of credit interests, and certain policies and regulations failing to match bankruptcy practice.²⁷⁵ In the rest of the section, the author will mainly discuss the problems with China’s bankruptcy and banking legislation.

(i) *The Disincentive Factors Within China’s Banking System*

a. Soft Budget Constraints on State Commercial Banks

²⁷² See Chinaonline, *supra* note 197.

²⁷³ See generally Mitchell, Janet, ‘Creditor Passivity and Bankruptcy: Implications for Economic Reform’, in Mayer, Colin & Vives, Xavier (eds.), *Capital Markets and Financial Intermediation* (1993).

²⁷⁴ For a detailed discussion of these issues, see generally Monfort, Mark E., ‘Reform of the State-Owned Enterprises and the Bankruptcy Law in the People’s Republic of China’, 22 *Okla. City U. L. Rev.* 1067 (Fall, 1997); Miller, Sheryl, *supra* note 267; and Harmer, Ronald Winston, *supra* note 270.

While the bank soft credits are now the main source of soft budget constraints on SOEs, the general budget constraints on China's State commercial banks remain soft as well. Despite the provisions of the Commercial Banking Law,²⁷⁶ State commercial banks in China are not operating independently and hence cannot assume their civil responsibilities independently.²⁷⁷ First, as previously mentioned, a significant proportion of their lending remains policy loans or loans conducted under informal government intervention, therefore they have to extend loans to SOEs regardless of their creditworthiness. This, together with the various administrative controls on commercial banks, makes it difficult to hold banks responsible for their own profit and loss. Second, because of their State ownership and the "too big to fail" logic, State commercial banks can always expect government bailout.

b. Inadequate Loan Classification and Provisioning Rules

In China, the main indices in the assessment of a bank's business volume are the balances of deposits and loans, interest receipts, and, closely related to the interest income, the bank's profits. Outstanding loans after liquidation when the borrower and its guarantor go bankrupt would be classified as irrecoverable loans²⁷⁸ and thus affect the banks' official evaluation. It is therefore understandable that bank managers, especially State commercial bank managers, would like to keep their borrowers afloat.

Moreover, unlike banks in most developed countries, which usually maintain adequate reserves for bad debts, Chinese banks have maintained a very low ratio of NPL provisions to total assets. The "big four" only started to provision for irrecoverable loans in 1988 at fixed percentages to their outstanding loans at the beginning of the year and the percentages ceiled the reserves.²⁷⁹ In 1992, the ceiling was increased to 1% of the total

²⁷⁵ See China News Agency, 'Central Bank Cites Impact of Bankruptcies' (Dec. 18, 1995), *translated in FBIS-CHI-95-243*, 62 (Dec. 19, 1995).

²⁷⁶ The Commercial Banking Law, *supra* note 8, art. 4.

²⁷⁷ See Harding, James, 'China Passes New Banking Law', *Fin. Times* (May 12, 1995).

²⁷⁸ Article 3, Interim Provisions on State Specialized Banks' Irrecoverable Loan Reserves, issued by the Ministry of Finance and effective as of January 1, 1988.

²⁷⁹ The percentages required were quite low then: 0.1% for working capital loans to industrial production enterprises, commercial enterprises and construction enterprises; 0.2% for loans to agricultural sector, loans to urban & township collective enterprises, and loans to private enterprises and individual proprietor; 0.15% for export & import loans; and 0.2% for foreign exchange loans, loans for fixed assets and loans for technology updating. No reserves were required for loans substituting budgetary grants, special-purpose loans trusted by

outstanding loans at the beginning of the year,²⁸⁰ and further increased to 1% of the year-end outstanding loans from 1998 on.²⁸¹ Extra provisions are not tax deductible.

c. Lack of Autonomy in Loan Write-off

Chinese banks do not have enough autonomy to write off NPLs. Before 1988, the “big four” were not allowed to write off any bad loans without specific approval from the State Council. After the implementation of the Enterprise Bankruptcy Law in 1988, a handful of firms were liquidated each year, but the banks still had little autonomy to write off loans they had extended to liquidated enterprises. Banks must get approvals from local PBOC branches, provincial PBOC branches, or even the State Council for writing off the irrecoverable loans.²⁸² The result appears to be that banks are required to keep on their books many loans to liquidated borrowers.²⁸³

In addition to creating disincentives for State commercial banks to file bankruptcy cases against their borrowers, the lack of autonomy in writing off NPLs also constitutes obstacle for debt restructuring — banks do not have many tools to use in enterprise debt restructuring.

(ii) *Problems With China's Bankruptcy Legislation*

China's current bankruptcy legislation comprises the Enterprise Bankruptcy Law and relevant provisions in the Civil Procedure Law. The Enterprise Bankruptcy Law,²⁸⁴ which

local governments and authorities in charge of the enterprise, loans secured with collateral, inter-financial-institution loans. *Id.* arts. 5, 6 & 7.

²⁸⁰ The ceiling for the year 1993 was set at 0.5%. Banks were required to increase their reserves 0.1% annually from the next year on until their reserves reached 1% of their total outstanding loans at the beginning of the year. Article 2, Circular Revising Interim Provisions on State Specialized Banks' Irrecoverable Loan Reserves, issued by the MOF and effective as of January 1, 1992.

²⁸¹ Circular of the Ministry of Finance on the Non-Accrual Loans and Loan Loss Provisions, *Chengshi Jinrong Bao* (July 21 1998).

²⁸² See the World Bank, *China: Financial Sector Policies and Institutional Development*, 94-95, a World Bank Country Study (1990).

²⁸³ In 1994, for example, the “big four” and the BOCOM applied altogether to write off RMB474m irrecoverable loans, only RMB4.172m was approved for writing-off.

²⁸⁴ The Enterprise Bankruptcy Law, *supra* note 266. To implement the law, the Supreme People's Court issued Opinions of the Supreme People's Court on Issues Concerning the Implementation of the Enterprise Bankruptcy Law (*zui gao ren min fa yuan guan yu guan che zhi xing zhong hua ren min gong he guo po chan*

applies to SOEs only,²⁸⁵ was adopted in 1986 and came into effect two years later on November 1, 1988. The Law provides for bankruptcy filing and case acceptance, creditor meetings, reconciliation and reorganization, bankruptcy declaration, and liquidation.²⁸⁶ Bankruptcy of entities other than SOEs is governed by the 1991 Civil Procedure Law.²⁸⁷ The Civil Procedure Law provisions are shorter, but basically replicate the main elements of the Enterprise Bankruptcy Law.²⁸⁸ It is likely that the basic rules and procedures in both cases will be similar in State owned enterprise bankruptcy and non-state owned enterprise bankruptcy.²⁸⁹ There are differences between the two laws as well.²⁹⁰

In the rest of this section, this author will focus on problems with China's SOE bankruptcy practices. From the author's point of view, problems with the Enterprise Bankruptcy Law and its enforcement result in the banks' passivity.

a. Problems with Bankruptcy Procedures

Under the Enterprise Bankruptcy Law, SOEs may be placed in bankruptcy proceedings when they have "suffered serious losses and cannot pay (their) debts because of poor management".²⁹¹ This qualifies the right of creditors to force involuntary proceedings by

fa ruo gan wen ti de yi jian). promulgated by the Supreme People's Court in November 1991 (hereinafter referred to as "the Supreme Court Bankruptcy Opinions").

²⁸⁵ The Enterprise Bankruptcy Law, *supra* note 266, art. 2.

²⁸⁶ For details of the proceedings provided by the Law, *see* Chen, Feng, 'Chinese Bankruptcy Law: Milestones and Challenges', 31 *St. Mary's Law Journal* 1, 49 (1999); *and also* Lam, Joseph & Kan, Carmen, 'Rules and Regulations on Insolvency and Restructuring in China', 11 *J.I.B.L.*, 351 (1999).

²⁸⁷ The Supreme Court Bankruptcy Opinions, *supra* note 284, art. 74, which provides that the bankruptcy of non-state-owned legal person enterprises should be governed by the Procedure for Bankruptcy and Debt Repayment of Legal Person Enterprises prescribed in the Civil Procedure Law. Chapter 19, Law of Civil Procedure of the People's Republic of China [*zhonghua renmin gongheguo minshi susongfa*], adopted by the fourth session of the seventh National People's Congress on April 9, 1991 and effective as of the same day, (hereinafter referred to as "the Civil Procedure Law").

²⁸⁸ The Civil Procedure Law, *supra* note 287, Chapter 19.

²⁸⁹ Article 253, Opinions of the Supreme People's Court on Issues Concerning the Implementation of the Civil Procedure Law (*zui gao ren min fa yuan guan yu shi yong zhong hua ren min gong he guo min shi su song fa ruo gan wen ti de yi jian*, adopted by the Judicial Committee of the Supreme People's Court at its 528th meeting), provides that civil courts addressing issues of the bankruptcy and debt repayment by non-State-owned enterprises can refer to the Enterprise Bankruptcy Law.

²⁹⁰ For a detailed discussion of the differences between the Enterprise Bankruptcy Law and the Civil Procedure Law, *see* Chang, Gordon G., 'Bankruptcy Law in China: too Much or too Little?', 13 *China Law and Practices* No. 5, 22-25 (June/July 1999).

²⁹¹ The Enterprise Bankruptcy Law, *supra* note 266, art. 3.

requiring proof that the debtor's losses are due to poor operation and management.²⁹² Creditors are also prohibited from filing bankruptcy case against public utilities and enterprises of major concern to the national economy and the general welfare of the public whose debts are to be repaid by government subsidies or through other arrangements with appropriate governmental departments.²⁹³ Although the burden of proof on creditors was mitigated to some extent by the Supreme Court Opinions of 1991,²⁹⁴ given the difficulties in discovering the financial condition of an enterprise due to underdeveloped accounting and disclosure practices in China,²⁹⁵ it is still not an easy job for a creditor to make the decision to initiate a bankruptcy case.

Even if the creditor succeeds in building up evidence and filing a bankruptcy case against its debtor, the bankruptcy proceeding is still subject to various government interventions.²⁹⁶ The enterprise bankruptcy will almost inevitably involve such government agencies as the auditing authority, the administration for industry and commerce, the tax authority, the price-control authority, the civil affair department, the land administration, the labor and personnel department, and the social security authority. Actually, in most circumstances, the court will have to seek the collaboration of the relevant government authorities in dealing with the insolvent enterprises. Sometimes, the court cannot even

²⁹² Theoretically, enterprises whose losses could not be anticipated and prevented are outside the bankruptcy net, even though they are deeply in debt.

²⁹³ The Enterprise Bankruptcy Law, *supra* note 266, art. 3.

²⁹⁴ The Supreme Court Bankruptcy Opinions, *supra* note 284. Respecting article 3 of the Enterprise Bankruptcy Law, the "Opinions" stated that an inability to discharge matured liabilities meant that the time for discharge or payment of such debt (or debts) had expired, a creditor had demanded payment; and the debtor was obviously deficient in liquidity. *Id.* art. 8. Article 8 of the "Opinions" provided that a debtor should be deemed incapable of discharging matured debts if it has ceased repaying due debts continuously. These provisions, together with the provisions that a creditor needs only prove its claims against the debtor and the debtor's incapability of repaying the due debt when filing bankruptcy against the debtor (article 2 of the "Opinions") have obviously mitigated creditors' burden of proof in filing bankruptcy case against its debtor.

²⁹⁵ Only with the assistance of a modern accounting system may the financial position of an enterprise fairly be ascertained. Because of the long period of command economy when accounting mechanisms were geared to provide basic cost and production information, it was not until mid-1993 that China began to adopt recognized and accepted international accounting techniques and standards. The accounting and disclosure practices remain poor in China. In addition to the poor accounting and disclosure practices, there are other obstacles in determining a SOE's real financial situation, including soft budget constraints, government intervention and great number of social burdens on SOEs. All these make it difficult in making a proper assessment of the SOE performance. *See, e.g.,* Monfort, Mark E., *supra* note 274, at 1067.

²⁹⁶ The Enterprise Bankruptcy Law is shot through with references over to discretionary actions by government authorities. Government authorities are involved in the composition and reorganization of the insolvent enterprise, the liquidation of the bankrupt enterprise, the settlement of the redundant employees of the bankrupt enterprise and their welfare before re-employment, and the investigation of the liability for the bankruptcy of the enterprise. The Enterprise Bankruptcy Law, *supra* note 266, arts. 4, 17, 20, 24 & 42.

declare the bankruptcy of an insolvent enterprise without the collaboration of all the relevant government authorities.²⁹⁷

The extensive government involvement makes bankruptcy cases unattractive to banks. In addition to the usual difficulties associated with multiple decision makers, it also results, in many cases, in a lengthy decision-making process; while an insolvency law that is proactive cannot be expected to provide benefits unless the process is permitted to operate quickly and efficiently, before the financial difficulties become acute and critical.

b. The Pro-employee Asset Distribution

According to article 37 of the Enterprise Bankruptcy Law, the assets of the bankruptcy estate will not go to the unsecured creditor before salaries and labor insurance benefits owed by the debtor are given to its workers and staff, and then the taxation obligation of the debtor is satisfied.²⁹⁸ A circular issued by the State Council in 1994 reiterates the bias in favor of employees. According to that circular, the first priority in a case of enterprise bankruptcy is to “resettle the employees in order to maintain order and stability in the society”.²⁹⁹ The circular provides that proceeds from the sale of land use rights (usually the most valuable property of the insolvent enterprise) should first be used to resettle the employees of the enterprise before it can be included in the bankruptcy estate for distribution;³⁰⁰ and if the proceeds from the sale of the land use rights cannot satisfy the resettlement requirements, other assets in the bankruptcy estate should be used for resettlement purposes.³⁰¹ Likewise, the housing, schools, nurseries, hospitals, and other welfare facilities of the bankrupt enterprise will no longer be the property of the bankrupt enterprise, but rather will be

²⁹⁷ See Wang, Zheng, ‘Going Bankrupt in Accordance with the Law-Practices in Shenyang’, *People’s Daily*, 18 November 1996. The dominant role of government in enterprise bankruptcy is clearly evidenced in the Bankruptcy of Achen Sugar Mill. The plant in Heilongjiang province was established in 1905, used to be one of the largest sugar mills in China. Because of poor management and heavy debt burdens, the enterprise stopped its production since 1993. At the end of 1997, the enterprise had asset worth only RMB0.28bn, while its debts (principals and interests) accumulated at RMB0.7bn. The company, however, was only able to apply for bankruptcy in June 1998 after the approval of the relevant government authorities. See Chen, Kaixing, ‘The Bankruptcy of Achen Sugar Mill Go to Its last Stage (*Achen Tangchang Pochan An Jingru Zhongjie Jieduan*)’, *People’s Daily (Oversea Edition)*, 1 (November 12, 1998).

²⁹⁸ The Enterprise Bankruptcy Law, *supra* note 266, art. 37.

²⁹⁹ The Circular on the Trial of Bankruptcy of State-owned Enterprises in Several Pilot Cities, issued by the State Council on October 25, 1994 under the authorization of Article 43 of the enterprise Bankruptcy Law, art. 1

³⁰⁰ *Id.* art. 2.

administered by the relevant government department, with their employees to be taken in or resettled by the unit that takes over the particular facility.³⁰²

In 1997, the State Council promulgated the Supplementary Notice on Issues Concerning the Trial Implementation in Several Cities of State-Owned Enterprise Bankruptcy and Merger and Re-employment of Staff and Workers.³⁰³ It creates fundamental changes in the rights of creditors (both secured and unsecured) provided by the Civil Procedure Law,³⁰⁴ the Security Law,³⁰⁵ and the Enterprise Bankruptcy Law,³⁰⁶ stripping them of their expectancy in a search for funds to pay for the resettlement and reemployment of employees of bankrupt SOEs. Creditors of bankrupt enterprises covered by the 1997 Notice — State-owned industrial enterprises in what are now the 111 cities³⁰⁷ in the State Council's Capital Structure Optimization Program for Enterprises — are now to be paid only out of assets remaining after the costs of resettlement have been met.³⁰⁸ Like the 1994 Circular, the 1997 Notice provides that the cost of the resettlement of employees shall be paid for first by revenues from the disposition of land use rights.³⁰⁹ The 1997 Notice, however, goes further to specifically state that land use rights that have been encumbered with security interests are also to be used for funding resettlement costs before any of the income from their dispositions is used to pay off secured creditors.³¹⁰ These provisions have seriously reduced the amount of any bankruptcy estate available for creditors. As a result, banks become the largest losers in enterprise bankruptcy.³¹¹

³⁰¹ *Id.* art. 3.

³⁰² *Id.*

³⁰³ The Supplementary Notice on Issues Concerning the Trial Implementation in Several Cities of State-Owned Enterprise Bankruptcy and Merger and Re-employment of Staff and Workers, issued by the State Council on March 2, 1997 (hereinafter referred to as "the 1997 Bankruptcy Notice").

³⁰⁴ The Civil Procedure Law, *supra* note 287, arts. 203-4.

³⁰⁵ The Security Law, *supra* note 159, art. 33.

³⁰⁶ The Enterprise Bankruptcy Law, *supra* note 266, art. 32.

³⁰⁷ The relevant cities are listed in an appendix to the 1997 Notice and include Beijing, Changchun, Changsha, Chengdu, Chongqing, Dalian, Fuzhou, Guangzhou, Haikou, Harbin, Jilin, Nanjing, Ningbo, Qingdao, Shanghai, Shenyang, Shenzhen, Tianjin, Wuhan, Xiamen and Wuxi.

³⁰⁸ See Clark, Donald C., 'State Council Notice Nullifies Statutory Rights of Creditors', 19 No. 4E. Asian Executive Rep. 9, 9 (April 15, 1997).

³⁰⁹ The 1997 Bankruptcy Notice, *supra* note 303, art. 5.

³¹⁰ *Id.*

³¹¹ E.g., in the Achen Sugar Mill bankruptcy case, after liquidation, the bankrupt enterprise had assets equal to RMB0.12bn. All of its assets were used to compensate its 4500 workers, the cost of which was estimated at RMB0.13bn. All Loan principal and interest, which equaled to RMB0.7bn, were written off. See Chen, Kaixing, *supra* note 297.

3. Policy Recommendation

One common effort made by Asian countries in the post-crisis era is to update their bankruptcy laws.³¹² In Thailand and Indonesia, the existence of significant amounts of “strategic” NPLs — borrowers taking advantage of the crisis to stop paying their loans and hide behind impotent or outdated bankruptcy legislation — have highlighted the need for reform to the bankruptcy laws. To facilitate the debt restructuring, the three Asian countries that received the IMF help (South Korea, Thailand and Indonesia) all amended their bankruptcy laws after their currencies collapsed in 1997 — a key condition for the multi billion-dollar bailouts led by the IMF.³¹³

A new bankruptcy law is urgently needed in China as well, given the inefficiency of its current bankruptcy legislation, which is actually a main cause of the creditor banks’ passivity in China. Besides, banks in China should be granted more discretion in writing off and provisioning for NPLs. Incentives must be provided to encourage banks to pursue positively their creditor’s rights.

B. THE LACK OF CONSENSUAL MECHANISMS TO FACILITATE NEGOTIATION BETWEEN CREDITORS AND DEBTORS

Consensual Mechanisms to promote debt restructuring vary from country to country. Three different models can be drawn worldwide, *i.e.* the statutory procedures provided in Chapter 11 of US Bankruptcy Code, the “London approach” and its variations in “Asian crisis countries”, and the bank-led restructuring represented by Poland (see Annex VI). Several common features can be identified for these three different institutional arrangements — *i.e.*, (1) a neutral party to co-ordinate the negotiation between creditors and debtors (*e.g.*, the court in the US Chapter 11 procedures, and the Bank of England in the London Approach); (2) the limitation on the ability of small creditors to block agreements; (3) the seniority of the

³¹² Officials of the IMF, the World Bank and its private sector arm, the International Finance Corporation, largely agree that the single main obstacle to progress on corporate reform in Asia is legal systems that cannot cope with corporate workouts. Because the basic bankruptcy and legal framework is not there, lenders had very little leverage to force restructuring. See, *e.g.*, Filder, Stephon, ‘IMF Presses Asia on Corporate Reform’, *Fin. Times* (December 5, 2000).

³¹³ See Cecil, Morella, ‘Asia Makes Slow Progress on Bankruptcies’, *Agence France-Presse* (May 16, 1999), available at ‘1999 WL 2603180’.

interim new financing over existing debt; and (4) a standstill of creditors. China will have to make appropriate arrangements so that creditors and debtors can negotiate for debt restructuring.

1. The Conciliation and Reorganization Procedure Provided by the Enterprise Bankruptcy Law Cannot Fit the Need of Debt Restructuring

The 1986 Enterprise Bankruptcy Law does contain provisions for debt restructuring. Chapter IV of the Law provides for a reconciliation and reorganization procedure (see Annex VII). The Chapter IV procedure, however, cannot satisfy the need for debt restructuring because of its obvious deficiencies.

First, the procedure can only be initiated by the government departments in charge of the debtor enterprise³¹⁴ and the reorganization will be administrated by these relevant government departments.³¹⁵ This greatly impedes the debtor and its creditors' discretion in deciding whether to negotiate for debt restructuring and how to implement debt restructuring. Second, unlike the Chapter 11 procedure of the US Bankruptcy Code, the reorganization under Chapter IV of China's Enterprise Bankruptcy Law can only happen when the bankruptcy petition is filed by creditors.³¹⁶ Third, the reorganization procedure provided by the Chinese Enterprise Bankruptcy Law does not have the limitation on small creditors' ability to block a reconciliation agreement.³¹⁷ Last but not least, the reorganization procedure provided by the Enterprise Bankruptcy Law has not provided seniority interim of the new financing over existing debts.

³¹⁴ The Enterprise Bankruptcy Law, *supra* note 266, art.17.

³¹⁵ *Id.*, art. 20.

³¹⁶ *Id.* art.17. This is considered a main obstacle to the restructuring of GITIC. A number of international banks have officially and unofficially commented on the possibility of having GITIC reorganized after it was declared insolvent by the Guangdong Provincial High People's Court. Had GITIC not been suddenly closed down on October 6, 1998 and had it not unexpectedly petitioned to be declared insolvent on January 11, 1999, creditors of GITIC would have been able to initiate insolvency proceedings against GITIC. The PBOC, as the superior department-in-charge of GITIC, would then have had the opportunity to apply for reorganization of GITIC. See Lam, Joseph & Carmen, Kan, *supra* note 286, at 356 & note 15.

³¹⁷ The Enterprise Bankruptcy Law, *supra* note 266, art. 16, which read as follows:

Resolutions of the creditors' committee must be approved by a majority of creditors present at the meeting who are entitled to vote and whose claims represent a majority of the total amount of unsecured claims. But, a resolution concerning a draft agreement must be approved by more than two thirds of the total amount of the unsecured claims.

Thus, if creditors representing up to one third of the total amount of the unsecured claims vote against the draft conciliation agreement, they can successfully block the adoption of the agreement.

2. The Main Bank System in China — Should China Develop Bank-led Debt Restructuring?

China has been implementing the main bank system since July 1996 under the PBOC Interim Measures.³¹⁸ In that year, 300 enterprises entered the pilot trial of the main bank system. The trial pilot was expanded to 500 enterprises in 1997.³¹⁹ Under the main bank system, each borrower is paired with a “main bank” lender — actually a designated bank branch — with which it keeps its “basic account” and from which it receives all of its loans (unless the “main bank” is unable to meet its demand) (see Annex VIII).

It seems that main banks are in a good position to lead enterprise debt restructuring, because they are often the largest creditors of the relevant enterprises, and they have the best knowledge of their clients. The Interim Measures Governing the Main Bank System in fact provide that enterprises are entitled to seek policy suggestion from their main bank about debt restructuring.³²⁰

As pointed out above, banks in China do not have sufficient expertise and experience, however. Besides, strict limitations are imposed on commercial bank business activities by the Commercial Banking Law.³²¹ Whether commercial banks in China can lead debt restructuring properly remains doubtful, especially when there is an almost exclusive bank-enterprise relationships.³²²

3. Out-of-court Procedure

One experience of “Asian crisis countries” in corporate debt restructuring is that in the absence of effective bankruptcy procedures, out-of-court procedures offer a mechanism for resolution. Almost all Asian crises countries turned to the “London approach” (see Annex VI). Since there is no available institutional arrangements in China’s Bankruptcy Law to

³¹⁸ Interim Measures Governing the Main Bank System [zhuban yinhang guanli zhanxing banfa], issued by the PBOC on June 29, 1996 and effective as of July 1, 1996.

³¹⁹ See China Daily, ‘China: Businesses Undergo Reforms’ (March 30, 1997).

³²⁰ Interim Measures Governing the Main Bank System, *supra* note 318, art. 17.

³²¹ The Commercial Banking Law, *supra* note 8, art. 43.

³²² Under China’s current main bank system, no other banks are allowed to enter bank-enterprise cooperation agreement with an enterprise before that enterprise ends its bank-enterprise cooperation relationships with its main bank. The exclusive bank-enterprise relationship often impels the bank and their enterprise customers into an alliance at the expense of general public interests.

facilitate corporate debt restructuring, given the weakness of Chinese banks,³²³ the author would argue that China should follow the model of “Asian crisis countries” and employ the “London approach” to promote debt restructuring. A remote argument here might be the success of this approach in Hong Kong:³²⁴ it will be easier for Mainland China to draw lessons and experience from Hong Kong because Hong Kong is now a special administrative region (SAR) of the People’s Republic of China.

Hawkins and Turner summarized ten important principles for the schemes in Thailand (see Annex IX). According to them, these principles apply to other schemes, such as those in Malaysia and Indonesia as well.³²⁵ These ten principles particularize the common features drawn from the three basic models of institutional arrangements to facilitate debt restructuring negotiation between the debtor and its creditors — *i.e.*, a neutral party to coordinate the negotiation between creditors and debtors, the limitation on the ability of small creditors to block agreements, the seniority of the interim new financing over existing debt, and a standstill of creditors.

The author would like to suggest that China design its out-of-court institutional arrangements on the basis of these four common features; some adjustments, though, will have to make to tailor the arrangements to the particularities in China. In addition to the standstill of creditors, which is essential for the success of debt restructuring, a special committee should be established to oversee the debt-restructuring, collective action problem should be considered, and, more importantly, debtor enterprises should be able to obtain finance during the restructuring period.

(i) *Who Should Take Responsibility for Corporate Sector Restructuring in China?*

³²³ One conclusion the IMF made about the Asian financial crisis workout is that resolving the corporate sector problem requires properly functioning banks as counterpart. It is therefore important to conduct bank restructuring first when the banks are overall weak. Only when prudential regulation on banks becomes tighter and better enforced, banks’ capital is enhanced to a certain standards can banks really lead financial restructuring of corporations. See Balino, Tomas J. T., Enoch Charles *et al.*, *supra* note 3, at 75-6.

³²⁴ In Hong Kong, the Association of Banks released “Guidelines on Corporate Difficulties” based on the London approach, in April 1998, with the support of Hong Kong Monetary Authority (HKMA). The present scheme has been quite successful. See, *e.g.*, Hawkins, John & Turner Philip, *supra* note 33.

For details of the Hong Kong Approach, see ‘Hong Kong Approach to Corporate Difficulties’, *Hong Kong Monetary Authority Quarterly Bulletin*, 13-7 (November 1999).

³²⁵ See Hawkins, John & Turner Philip, *supra* note 33.

Given the authorized functions and responsibilities of the SETC concerning the national economy and SOEs,³²⁶ and the dominant role it is already playing in supervising the debt-equity swap scheme,³²⁷ the author would like to suggest that the SETC, together with the PBOC, establish a special committee to co-ordinate the negotiation between creditors and debtors regarding debt restructuring. The decisions made by the committee should bind both parties.

(ii) *Collective Action Problem in Debt Restructuring*

When many lenders hold claims on a borrower, the problem of attaining collective action must be taken account of. The collective action problem fully demonstrated itself in the Latin America debt crisis. In several cases, it has taken more time to persuade and cajole a sufficient number of banks to participate in the workout loan than to negotiate the agreement between the bank steering committee and the debtor.³²⁸ The collective action problem shows the importance of limiting the ability of small creditors to block agreements (in the US Chapter 11 procedure, the “cramdown” of the reorganization plan by the court: see Annex VI).

The sale by any creditor of his debt claim causes problems for the debt restructuring and should be conditioned as well, because the buyer may impede the restructuring process. That is why it is set as a principle in the Thai scheme that any creditor who sells his debt

³²⁶ These include: (1) regulating and solving problems in the operation of the national economy, and drafting objectives and policies for future operation; (2) overseeing the drafting and implementation of State industrial policies and comprehensive trade laws and policies, and directing the readjustment of the industrial structure; (3) managing the power, medicine, gold, silk and satin industries through corresponding bureaus; (4) planning industry investment distribution, directing use of commercial loans for projects not funded by the state, drafting policies for and supervising the use of foreign investment, drafting policies concerning the transfer of assets, equity and management power by SOEs to foreign investors, and helping enterprises internationalize their operations; (5) reforming the goods distribution system and market system, regulating the supply and demand of major commodities, coordinating internal and external trade policies, and planning the import/export and shipment of major manufactured goods and raw materials; (6) macro-managing all enterprises, drafting policies for reforming SOEs and lightening their financial burdens, promoting the development of large enterprise groups as well as small and mid-sized enterprises, managing the internal legal work of enterprises, training their managerial staff, and drafting policies, etc. for supervising enterprises' state property; and (7) directing enterprises' technical renovation, technology imports, localization of major imported equipment, R&D of technical equipment and resource utilization, organizing industries' environmental protection efforts, and developing the environmental protection industry. See the State Council Secretary Department (ed.), *The Organization Structure of the Central Government [zhongyan zhengfu zhuzhi jigou]* 122-130 (1998).

³²⁷ AMC Regulations, *supra* note 91, art. 23.

³²⁸ See generally Herring, Richard, J. 'The Economics of Workout Lending', 21 *Journal of Money, Credit, and Banking* No. 1, 1 at 10 (Feb. 1989).

claim should ensure that the buyer does not impede the restructuring process (see Annex IX). Besides, the “Bangkok approach” requires that creditors should take account of the impact of any action on other creditors and on potentially viable debtors (see Annex IX).

The situation in China is much simpler. Because the “big four” are entirely owned by the State, the government could undertake coordination and persuasion easily if banks cannot reach agreement themselves. In the current debt-equity swap scheme, the rule seems that the largest creditor takes the lead.³²⁹ If a debtor has creditors including foreign banks, or other non-bank foreign or domestic institutions, the collective action problem will emerge, however. It is therefore better if clear rules could be set in advance to solve the problem.

(iii) *Pro-claim debts*

a. The Economics behind the Pro-claim Debt

Permission to issue prior-claim debt is a basic feature of the Chapter 11 procedure of US Bankruptcy Code.³³⁰ By providing the troubled borrower with protection against the claims of past creditors, the issuance of prior-claim debt permits the borrower to finance productive new projects that have an expected return greater than the opportunity cost of funds. In the absence of such protection, it may be impossible to finance such projects because new lenders would be deterred by the knowledge that all returns from the new project would have to be shared with past creditors who hold unsatisfied claims on the borrower. Permitting the borrower to issue new debt that has a prior claim over existing indebtedness will not only benefit the debtor, but also the existing creditors — heavily exposed lenders are no longer “obliged” to advance new funds and can thus avoid to exacerbate concentrations of exposure to the troubled debtor.

The merits of the pro-claim debt explain why seniority is granted to interim new financing over existing debts even in out-of-court institutional arrangements for debt restructuring. In Thailand, for example, under the “Bangkok approach”, new credit extended

³²⁹ That is similar to the principle 4 of the “Bangkok Approach”.

³³⁰ Countries without this system are now considering including that in their insolvency laws. See, e.g., Kelly, Jim, ‘Investing: Insolvency Laws Must be Given US-Style Shake-up’, *Fin. Times* (April 26, 1999).

on reasonable terms to help the debtor continue operations is granted priority status (see Annex IX).

b. The Closed-end Loan in China: Is it a Pro-Claim Debt?

China's Enterprise Bankruptcy Law contains no provisions on pro-claim debt. On July 26, 1999, Interim Measures Governing Closed-end Loans was issued, aiming to facilitate closed-end loans to loss-making SOEs that would otherwise not be eligible for bank loans.³³¹

The closed-end loans are working capital loans issued to industrial SOEs, which are suffering from excessive leverage or losses and ineligible for normal banks loans.³³² According to the Interim Measures, closed-end loans are commercial loans, rather than policy loans and should only be issued at the discretion of commercial banks.³³³ Companies eligible for the loans must already have some marketable and profitable products, and must promise that the loans be used only for productive activities, and not to pay off old debts.³³⁴ The borrowers must put the loans in a special bank account with withdrawals requiring the approval of the creditor banks.³³⁵

The closed-end loans are to some extent similar to pro-claim debts, in terms that both of them are aiming at financing loss-making borrowers to grow out of their difficulties. There are differences between them, however. First, closed-end loans will only be provided to those loss-making SOEs that governments at or above the county level already decide to help (with a detailed aid plan).³³⁶ Those SOEs which are listed in the government plans to go bankrupt or go through M & A in three years are not eligible for closed-end loans.³³⁷ In other words, closed-end loans are not designed for enterprises under debt restructuring. Second, unlike pro-claim debt, closed-end loans do not have priority over existing debts, what the banks have is that the borrowers must put the loans in a special bank account with withdrawals

³³¹ Interim Measures Governing Closed-End Loans [Fengbi Daikuan Guanli Zhanxing Banfa], issued jointly by the PBOC, the MOF, the SETC, the State Tax Bureau, and the State Development and Planning Commission on July 26, 1999. The issuing of closed-end loans to foreign trade companies is not regulated by the Interim Measures. *Id.*, art. 23.

³³² *Id.* art. 2.

³³³ *Id.* art. 3.

³³⁴ *Id.* arts. 5 & 6.

³³⁵ *Id.* arts. 12-15.

³³⁶ *Id.* arts. 2 & 5.

³³⁷ *Id.* art. 23.

requiring the approval of the creditor banks. Proceeds from the sale of the products must be fully put in the special account and must not be used for other purpose.³³⁸ And, before the full repayment of the principal and interest of the closed loans, the borrowers cannot use the loans to pay off existing debts (including wages in arrears); tax authorities are not allowed to collect tax from the special account; and the people's courts shall not freeze the special account or order the borrower to pay off debts from that account.³³⁹

Given the fact that closed-end loans have existed in China for more than 2 years³⁴⁰ and that commercial banks, the PBOC, and other government departments have all accumulated experience with closed-end loans, the author would suggest that closed-end loans be applied to enterprise debt restructuring. Necessary adjustments, though, should be made so that closed-end loans can fit the need for debt restructuring — enterprises under debt restructuring should be eligible for closed-end loans, rather than just those included in the government aid plan. Besides, it must be clarified that closed-end loans have seniority over existing debts of the borrower.

VII. SUMMARY

Recapitalization is the core of any bank rehabilitation strategy. The government recapitalization of the “big four” can be justified by the State ownership of the “big four”, the low profitability of banks, and their difficulties in raising capital. The problem here is not whether public money should be injected into the “big four”, but how the money should be injected so as to mitigate the moral hazards accompanying public capital injection. The failure of the 1998 RMB270bn recapitalization led to the establishment of four AMC's in 1999. The AMC's were mandated to issue bonds guaranteed by the MOF to their respective banks in exchange for NPLs. Banks are virtually capitalized in this way.

³³⁸ *Id.* art. 15.

³³⁹ *Id.* art. 14.

³⁴⁰ Banks in China started issuing closed-end loans to foreign trade enterprises as early as in the second half of 1997. In September 1997, the Provisional Procedure on the Management of Closed-End Loans to Foreign Trade Companies is issued jointly by the PBOC and other four state departments. *See, e.g., AsiaPort Daily News, 'New Loan Procedure Supports Exports' (September 2, 1997), available at '1997 IWL 22634372'.*

By the end of 1998, a total amount of RMB9.8bn in closed-end loans was issued. *See Wang, Baoqing, 'PBOC Official Explains the Interim Measures Governing Closed-End Loans to Reporter [jiu fengbi daikun guanli zhanxing banfa, renhang youguan fuzeren da jizhe wen]', Jingrong Shibao, 1, 2, (August 3, 1999).*

There are problems with China's AMC program, however. AMCs in China are not simply tasked to solve the bank NPL problem, but also mandated to help SOEs grow out of their difficulties. Moreover, whether the incentives and capacity of AMCs to deal with NPLs collected from banks are sufficient remains doubtful. Last but not least, there are legal obstacles to AMCs' smooth operation in China: (1) It is not clear whether the borrowers must be notified of AMCs' take-over of the loans from the banks, as required by China's contract law. (2) AMCs must take cautions to accomplish legal procedures for the transfer of security interests on the loans. (3) The borrowers' right to assert against AMCs their defenses against banks may prove troublesome. Efforts must be taken to solve these problems appropriately.

Collecting NPLs from banks is only the first step. NPL management is a more crucial step for the success of bank and enterprise restructuring. There are two basic strategies for managing NPLs: one is to dispose them as quickly as possible (asset management strategy), the other is that AMCs hold and try to restructure the NPLs in an expectation of returns in the future (loan management strategy). AMCs in China are mainly applying a debt-restructuring strategy towards the NPLs they collected, mainly in the form of debt-equity swaps, although they will have to dispose at least some of the NPLs they collected.

A sweeping debt-equity swap scheme has been carried out in China, attempting to solve the bank and enterprise problem simultaneously. This scheme, however, bears heavy moral hazards. Moreover, there are obstacles for AMCs to dispose of the equity they acquired via the swaps.

A solid legal infrastructure is a necessary precondition for the success of the AMC program and NPL management in China. An AMC Law should be adopted by the NPC or its Standing Committee so that AMCs will have more authority to manage NPLs. Besides, China must reform its bankruptcy legislation and banking regulation regime so that banks will be more proactive in collecting their loans. Moreover, an out-of-court consensual mechanism must be established to facilitate debt restructuring, featured with a neutral party to co-ordinate the negotiation between creditors and debtors, the limitation on the ability of small creditors to block agreements, the seniority of the interim new financing over existing debt and a standstill of creditors.

Chapter Three NON-PERFORMING LOAN PREVENTION — ENHANCING
PRUDENTIAL REGULATION AND SUPERVISION, PROMOTING
BANK INTERNAL CONTROL SYSTEMS

I. INTRODUCTION

The inappropriate banking regulation and supervision, and weak internal controls in commercial banks have been identified as two main causes of the bank NPL problem in China. To prevent the creation of new NPLs, efforts should be taken to enhance banking regulation/supervision and to improve bank internal controls.

After decades of development, the PBOC has developed from the country's mono-bank into a central bank in charge of monetary policy operation and financial regulation and supervision. As one of the country's three financial supervisors,¹ the PBOC carries out prudential regulation/supervision against over-risk-taking and irregularities of banks and other financial institutions under its supervision (see Annex X). Moreover, the 1995 Central Banking Law² establishes the PBOC operational independence and authorizes it adequate resources to carry out banking regulation and supervision (see Annex XI). The independence of the PBOC was further enhanced through the organizational restructuring at its headquarters and local levels (see Annex XI), which cuts off the intervention of local governments into the PBOC's monetary policy operation and financial supervision and guarantees a more efficient financial supervision.

In this chapter, comments will be made on China's current banking regulation and supervision as compared with the Basle Committee Core Principles for Effective Banking Supervision. Issues related to bank internal controls in China would also be discussed.

¹ They are: the PBOC in charge of banking supervision, CSRC supervising the securities businesses, and China Insurance Regulatory Commission (CIRC) supervising the country's insurance industry. See Annex X.

² The Law of the People's Republic of China on the People's Bank of China, adopted at the 3rd Session of the 8th NPC on March 18, 1995, effective as of the same day (hereinafter referred to as "the Central Banking Law").

The rest of the Chapter is organized in four sections. Section II discusses the progress in removing unnecessary administrative controls on banks. In Section III, comments are made on China's current banking regulation and supervision, as compared with the Basle Committee Core Principles for Effective Banking Supervision. Section IV reviews the development of bank internal controls in China, in comparison with the Basle Committee Framework for Internal Control Systems in Banking Organization. A summary is offered in Section V.

II. REMOVING UNNECESSARY ADMINISTRATIVE CONTROLS ON STATE COMMERCIAL BANKS

The causal relation between administrative controls on State commercial banks and their NPL problem has been fully explored in Chapter One. As mentioned in that chapter, the division of business scope among State specialized banks was removed as early as mid 1980s. In this section, this author will concentrate on the removal of credit plan and the relaxation of interest rate controls.

A. INDIRECT MONETARY POLICY INSTRUMENTS VS. DIRECT MONETARY POLICY INSTRUMENTS

As indicated in Chapter One, administrative controls on commercial banks result from the PBOC's over-reliance on direct monetary policy instruments. The situation has changed since 1993, with the gradual removal of some administrative controls on commercial banks.

In 1993, the State Council promulgated the Resolution on Financial Reform,³ calling for more reliance on indirect monetary policy instruments. The Resolution, however, retained the credit plan as one of the main monetary policy instruments.⁴ Following the Resolution, the 1995 Central Banking Law⁵ provided the PBOC with market-oriented mechanisms, such as deposit reserve requirements, base interest rate fixture, rediscounting windows, central bank's credit to commercial banks, and open market operation to implement monetary policy.

³ Resolution on Financial Reform, State Council, No. 91 (1993).

⁴ *Id.* sect. 1.

⁵ The Central Banking Law, *supra* note 2, art. 22.

The credit plan was not even listed as a specific monetary policy tool. The PBOC, however, was not completely prohibited from using direct instruments to implement monetary policy. Article 22 of the Central Banking Law provided that the PBOC, in addition to the listed indirect instruments, could apply other monetary policy instruments defined by the State Council. Actually, the credit plan continued its application after the implementation of the Central Banking Law.⁶ Besides, the central bank is still controlling commercial banks' RMB deposit and lending interest rates.⁷

B. CREDIT GUIDANCE VS. CREDIT PLAN

1. The Removal of Credit Plan

The economic reform in China has observed the gradual relaxation of credit plan. The traditional distinction between budget funds for financing enterprise fixed capital/quota working capital, and bank credits for financing enterprise above-quota working capital was abandoned shortly after the initiation of the economic reform. Credits were increasingly used to finance not only enterprise working capital but also fixed capital requirements.⁸

From the mid-1980s, efforts were made to eliminate overall direct credit controls on bank lending. For many years before 1985, banks submitted deposits to their headquarters, received targets for loan making, and requested funds when they needed them.⁹ This strict management of credit funds guaranteed the full implementation of credit plan. Since 1985, the central bank began to adopt a method of dividing funds among specialized banks and linking the amount of loans made by them to the deposit they took. The central bank was no longer the only supplier of funds to specialized banks. Banks could borrow in financial markets as well.¹⁰ As a result, though credit ceilings continued to be assigned to specialized

⁶ See, e.g., Xinhua News Agency, 'Financial System Reform to Move into New Stages', available at '1999 WL 7302553'.

⁷ The Central Banking Law, *supra* note 2, art. 5.

⁸ Circular of the State Council Approving The Report of the People's Bank of China on PBOC's Mono-Management of State-Operated Enterprises' Working Capital, issued by the State Council on June 25, 1983; and Report of the PBOC Concerning the Division of Business Scope in Fixed Asset Loans Among Specialized Banks, approved by the State Council on May 13, 1984.

⁹ Decisions of the State Council On the PBOC's Exclusive Role as Central Bank, issued by the State Council on September 17, 1983, art 3. That article confirmed the system.

¹⁰ See, e.g., Dai, Gengyou, 'A Review of PBOC's Monetary and Credit Policy', *China Finance (Beijing)* No. 12, 27 (1999).

banks in accordance with the annual credit plan,¹¹ they were virtually no longer mandatory.¹² Although the direct credit control was reintroduced in the late 1980s as inflationary pressures mounted, the State commercial banks already possessed some autonomy in extending working capital loans, which accounted for 60% of the credit plan.¹³

A new round of financial reform started in 1993.¹⁴ The establishment of the three policy banks, and the adoption of the Central Banking Law and Commercial Banking Law, increased the autonomy of State commercial banks in their lending activities. Although the credit plan was strictly enforced in 1994 and 1995, State commercial banks were granted increasing autonomy in making investment-lending decisions within their individual credit ceilings and gained some independence to pursue commercial objectives.

In 1994, the PBOC issued new prudential ratios in pilot form to guide the operations of banks and non-bank financial institutions,¹⁵ requiring banks to keep their loan-deposit ratio below 75%.¹⁶ The new ratios were introduced to complement the credit plan. Credit ceilings, however, still applied to banks whose lending volume exceeded the prescribed loan-deposit ratio and banks that did not have stable deposit resources.¹⁷ The 1995 Commercial Banking Law legitimized asset-liability management ratios.¹⁸ In 1997, the application of credit plan was limited to the "big four" and the three policy banks.¹⁹ On December 24, 1997, the PBOC

¹¹ Interim Regulations of the People's Republic of China on Bank Administration, issued by the State Council on January 7, 1986, art. 35.

¹² See generally the World Bank, *China: Finance and Development* (1988).

¹³ The banks' freedom to allocate investment loans, however, was still circumscribed by a detailed lending program drawn up by the State Planning Commission in consultation with the central bank, the MOF, and the SETC. See generally the World Bank, *The Chinese Economy: Fighting Inflation, Deepening Reforms*, 27, a World Bank Country Study (1996).

¹⁴ In November 1993, the Third Plenum of the Fourteenth National Congress of the CCP set the future course of financial sector development in China. See generally 'Decisions on Issues Concerning the Establishment of the Socialist Market Economy System', *Beijing: Xinhua Monthly* 6 (November 1993).

¹⁵ Circular of the PBOC Concerning the Asset-Liability Management of Commercial Banks, issued on February 15, 1994 (hereinafter referred to as "the 1994 PBOC Circular on Asset-Liability Management").

¹⁶ See generally Appendix to the Circular of the PBOC Concerning the Asset-Liability Management of Commercial Banks, issued on February 15, 1994; the World Bank, *supra* note 13, at 28; and Fernando, Montes-Negret, 'China's Credit Plan: An Overview', 11 *Oxford Rev. of Econ. Pol'y* No. 4, 25, Box 2 (Winter, 1995).

¹⁷ The 1994 PBOC Circular on Asset-Liability Management, *supra* note 15, art. 6.

¹⁸ The Law of the People's Republic of China on Commercial Banks, adopted at the 13th Session of the Standing Committee of the 8th NPC on May 10, 1995, and effective as of July 1, 1995 (hereinafter referred to as "the Commercial Banking Law"), art. 39.

¹⁹ See Editorial Comment, 'A Major Reform to Macro Financial Regulation and Control [jingrong hongguang tiaokong de zhongdagaige]', *People's Daily*, (December 26, 1997). The three policy banks are still subject to credit ceiling control. See Circular on Improving the Loan Size Management for State Commercial Banks [zhongguo renmin yinhang guanyu gaijing guoyou shangye yinhang daikuan guimo guili de tongzhi], issued by the PBOC on December 24, 1997 (hereinafter referred to as "the Circular on Improving the Loan Size Management").

issued a Circular announcing the abolition of the ceiling control on State commercial banks' loan sizes since January 1, 1998.²⁰

2. The Introduction of Credit Guidance

The removal of credit plan does not mean that the PBOC is to carry out a complete *laissez-faire* policy towards bank lending. According to the PBOC Circular, after the abolishment of compulsory credit plans, commercial banks should issue loans according to lending rules set by the PBOC and industrial policies set by the government.²¹

A new bank credit management system was introduced immediately after the phasing-out of the credit plan.²² Under the new system, the PBOC formulates annual and quarterly guiding plans for the new lending of commercial banks since January 1, 1998. Unlike the former compulsory plan, the new guiding plan is not binding to commercial banks (including the "big four").²³ Commercial banks are now entitled to issue loans with their legally raised money after depositing required reserve, leaving adequate standby reserve, repaying loans falling due to the PBOC, and purchasing policy financial bonds.²⁴

The headquarters of each commercial bank is required to draft and issue annual and quarterly credit plans for the whole bank on the basis of the PBOC guiding plans, credit policies, and asset-liability ratio management requirements. The banks must file these plans with the PBOC.²⁵

3. The Implication of the Reform

According to Dai, Xianglong, the removal of mandatory credit plans represents the shift from direct to mainly indirect regulation and control of monetary policy and has deep ramifications

²⁰ *Id.*

²¹ *Id.* "The reform of the credit fund management policy should not result in less support to enterprises, should not result in any negative impacts on the implementation of state industrial and regional development policies."
Id.

²² *Id.*

²³ The guiding plan sets an indicative, non-binding target. The guiding plan to State commercial banks for the year 1999 covered bank lending worth of RMB1000bn. See Dai, Xianglong, 'PBOC Will Follow an Appropriate Monetary Policy and Focus on Improving Financial Supervision to Promote Sound Economic Development and Guarantee Financial Safety', *China Finance* No. 2, 4, at 4 (February 1999).

²⁴ See the Circular on Improving the Loan Size Management, *supra* note 19.

²⁵ *Id.*

for China's financial reform.²⁶ In terms of the commercialization of the "big four", the introduction of the new system levels the playing field for them to compete with other commercial banks and forces them to improve their internal controls.²⁷

The achievement of these goals, however, depends on many factors. Ultimately, the shift from direct to mainly indirect regulation and control of credit will depend on much greater flexibility of interest rates on lending, greater sensitivity of banks to costs, and on further reforms in the corporate sector that increase the sensitivity of firms to the interest rate charged on loans. Otherwise, the PBOC will have to rely mainly on direct control instruments.²⁸

C. DECONTROL OF INTEREST RATES

The negative effects of interest rate controls were discussed in Chapter One. In this subsection, this author will discuss China's current RMB interest rate control system, the efforts so far in liberalizing the interest rates, and the future of RMB interest rates administration in China.

1. China's Current RMB Interest Rate Administration System under the 1999 Interest Rate Administration Provisions

China's current interest rate control system is provided by the 1999 PBOC Interest Rate Administration Provisions.²⁹ The Provisions apply to financial institutions, postal savings, and other legal persons or organizations who engage in RMB deposit-taking or lending activities within the territory of the PRC (excluding Hong Kong, Macao and Taiwan).³⁰

²⁶ See Xue, Fei & Yang, Bin, 'Press Conference on China's Financial Situation Held by the 1st Session of the 9th NPC (*Shidang zhengjia huobi gongyingliang, baochi guoji shouji pingheng*)', *People's Daily (Overseas Edition)*, 2 (March 9, 1998).

²⁷ See the Circular on Improving the Loan Size Management, *supra* note 19.

²⁸ At least in 1999, most of the credits were still directly regulated and controlled. See, e.g., Qiu, Bin & Bian, Weigang, 'On Bank Lending Strategy Adjustments [*qiantan xinxingshi xia yinghang xindai chele de tiaozheng*]', *China Finance* No. 7, 10, at 10 (1999).

²⁹ Provisions on RMB Interest Rate Administration [*renminbi lilv guanli guiding*], promulgated by the PBOC on March 2, 1999, effective as of April 1, 1999 (hereinafter referred to as "the 1999 Interest Rate Administration Provisions").

³⁰ *Id.* art. 2.

The 1999 Interest Rate Administration Provisions authorize the PBOC to take the responsibility of interest rate administration, free of interruption from any other institution or individual.³¹ The Provisions divide the responsibilities between the PBOC headquarters and its branches and sub-branches. The headquarters' responsibilities include formulating interest rate policies and administrative regulations, fixing and adjusting interest rates, supervising and monitoring interest rates, and planning for the reform of interest rate administration system in China.³² The PBOC branches and sub-branches should, under the authorization of the headquarters, carry out the day-to-day supervision and monitoring of interest rates, establish and improve interest rate illegalities reporting system, propagate and explain interest rate policies and relevant laws and regulations to the public, and organize survey and research on interest rate policies.³³

According to the 1999 Interest Rate Administration Provisions, the PBOC is responsible for stipulating the PBOC deposit, lending and re-discounting interest rates, deposit and loan interest rates for commercial banks and other financial institutions, preferential lending interest rates, penal interest rates, inter-bank deposit interest rates, and interest rate floating scope.³⁴ The interest rates stipulated by the PBOC are legally binding and may not be changed by any institution or individual.³⁵ Individual financial institutions, however, are allowed to determine floatable interest rates within the scope set by the PBOC, interest rates for internal fund flows, inter-bank interest rates and discount rates.³⁶ Financial institutions must take the responsibility of internal interest rate management, propagating and explaining interest rate policies to their clients, accepting the interest rate examination and inspection of the PBOC, and reporting to the PBOC on issues arising out of the implementation of interest rate policies.³⁷

2. Efforts towards the Liberalization of Interest Rates

(i) *Establishing and Improving the Floating Rate System*

³¹ *Id.* art. 3.

³² *Id.* art. 7.

³³ *Id.* art. 8.

³⁴ *Id.* art. 5.

³⁵ *Id.* art. 3.

³⁶ *Id.* art. 6.

³⁷ *Id.* art. 9.

The establishment and improvement of the floating rate system has played a critical role in liberalizing China's interest rate regime.³⁸ The floating rate system started with rural credit cooperatives in December 1981.³⁹ In the 1980s, rural credit cooperatives, and trust and investment companies were authorized to raise their deposit rates up to ceilings stipulated by the PBOC.⁴⁰ The deposit interest rate floatation, however, resulted in the flight of deposit from banks to rural credit cooperatives and trust and investment companies. To compete with the cooperatives and trust and investment companies, other financial institutions had to raise their deposit interest rates, even without the authorization of the PBOC.⁴¹ The PBOC therefore deprived trust and investment companies of their right to raise deposit interest rates in 1985, and removed that of rural credit cooperatives in 1990.⁴² Afterwards, financial institutions have never been allowed to float their deposit interest rates again.

The ceilings and floors for the floatation of lending rates have varied during the reform era. At the very beginning, there were only ceilings for bank lending interest rates. By 1990, financial institutions were allowed to raise their working capital lending rates up to 30% higher than the basic rates.⁴³ In 1996, to lower the interest rate burden of enterprises, the ceiling for the floatation of working capital lending rate was lowered to 40% and 10% respectively for rural credit cooperatives and other financial institutions (commercial banks and non-bank financial institutions).⁴⁴

From 1986 to 1988, fixed-asset lending rates could be raised up to 20% higher than the basic rates. The ceiling was raised to 30% after February 1989, but was lowered to 20% again in February 1999.⁴⁵

³⁸ See, e.g., Zhou, Rongfan, Chao, Deyun, 'The Reform and Development of China's Floating Interest Rate System' [woguo fudong lilv zhidu de gaige he fazhan], *China Finance* No. 10, 23 (1998).

³⁹ Rural credit cooperatives were allowed to have deposit and lending interest rates higher than that of banks then. *Id.*, at 23.

⁴⁰ To stimulate the development of trust and investment companies, they were authorized to float their deposit rates up to 20% higher of bank deposit interest rates in the early part of the 1980s. Rural credit cooperatives were authorized the same floating right in 1987. In 1989, rural credit cooperatives were authorized to raise their deposit interest rates up to 70% higher than that of bank deposit interest rates. *Id.*

⁴¹ *Id.*

⁴² *Id.*

⁴³ *Id.* Credit cooperative enjoyed higher ceilings. Rural credit cooperatives were allowed to raise their lending rates up to 100% higher than that of the basic rate. The highest ceiling for urban credit cooperatives was 50%. *Id.*

⁴⁴ *Id.*

⁴⁵ *Id.*

It was not until 1990 that banks were allowed to lower their lending rates. To stimulate the economy and to carry out the government industrial policies, in April 1990, the PBOC set a floor for working capital lending rates at 10% lower than the basic interest rates.⁴⁶

In October 1998, to stimulate lending to small and medium-sized enterprises, the PBOC allowed wider rate floating scope for lending to small enterprises. Rural credit cooperatives were allowed to float their lending rates up to 50% higher and down to 10% lower than basic rates when they lent to small enterprises; while the scope for commercial banks, urban credit cooperatives were set at 20% (ceiling) and 10% (floor).⁴⁷ The scope was further widened in September 1999. Commercial banks, urban credit cooperatives were allowed to raise interest rates up to 20% higher than basic rates when they lend to small and medium-sized enterprises.⁴⁸

To improve the floating rate system, in August 1993, the PBOC required that individual financial institutions formulate detailed implementation measures to carry out the floating rate system, which involves charging different interest rates to their borrowers within the floatation scope on the basis of government industrial policies and the borrower's creditworthiness. After the widening of the floating scope in October 1998, commercial banks and urban credit cooperatives formulated new implementation measures accordingly.⁴⁹

The development of floating rate system is granting banks more and more discretion in deciding lending rates. First, the floatation scope and the application of floating rates have been widened. Second, the October 1998 and September 1999 policies no longer distinguished between working capital lending and fixed-asset lending. Third, financial institutions are now required to decide lending rates within the stipulated floating scope on the basis of the loan size and the risk involved, the borrower's creditworthiness and its liability-asset ratios, and whether the loan is secured.⁵⁰

(ii) *The Reform of Loan Interest Rate Categorizing and Calculation Measures*

⁴⁶ *Id.*

⁴⁷ *Id.*, at 24.

⁴⁸ *Id.*

⁴⁹ *Id.*, at 23.

⁵⁰ *Id.*, at 24.

For a long time in China, loans were divided into working capital loans and fixed-investment loans with different interest rates set for loans of different categories.⁵¹ With the deepening of the financial reform, especially the phasing-out of credit ceiling controls, it becomes unnecessary to set interest rates separately for working capital loans and fixed-investment loans. The 1999 Interest Rate Administration Provisions therefore divide loan interest rates into short-term loan interest rates and medium- and long-term loan interest rates.⁵² In other words, loan interest rates are now set on the basis of the term of the loan rather than the purpose of the loan.

Financial institutions in China had no freedom in deciding how interests should be calculated and collected.⁵³ The 1999 Interest Rate Administration Provisions at least grant financial institutions some freedom in deciding how interests on short-term loans should be calculated and collected. Financial institutions and their borrowers can now decide to calculate and collect interests on short-term loans either monthly or quarterly.⁵⁴

3. Prospects of Interest Rate Liberalization in China

The Chinese government is determined to liberalize RMB interest rates. As early as 1993, a limited scope for interest rate administration system reform was defined.⁵⁵ The State Council's Resolution on Financial Reform in 1993 called for a reform of interest rate policies and vested the power to formulate policy decisions in the PBOC under the leadership of the State Council.⁵⁶ The PBOC, accordingly, formulated a plan to liberalize interest rates in three

⁵¹ *Id.*, at 23.

⁵² The 1999 Interest Rate Administration Provisions, *supra* note 29, arts. 20 & 21.

⁵³ See Zhou, Rongfan, Chao, Deyun, *supra* note 38, at 24.

⁵⁴ The 1999 Interest Rate Administration Provisions, *supra* note 29, art. 20.

⁵⁵ See 'Decisions on Issues Concerning the Establishment of the Socialist Market Economy System', *supra* note 14. It was stated that the central bank should adjust the basic interest rate in a timely fashion according to the demand and supply of funds in the market, and allow the deposit and lending rates of commercial banks to float within a limited margin. *Id.*

⁵⁶ Resolution on Financial Reform, *supra* note 3, sect. 4.

stages,⁵⁷ with the inter-bank market rate liberalization as the first stage, followed by the lending rate liberalization and finally the deposit rate liberalization.⁵⁸

Progress has been made in this area. On June 1, 1996, ceilings on inter-bank lending interest rates were abolished.⁵⁹ With the establishment and improvement of the floating rate system, financial institutions can now charge different interest rates on the basis of their borrowers' creditworthiness within the floating scope.⁶⁰ Since September 21, 2000, financial institutions have been allowed to set their foreign currency lending rates in line with that of international markets; rates on foreign currency deposit of more than US\$3m have also been liberalized.⁶¹ To date, the liberalization of interest rates, however, has not touched the foundation of the interest rate controls in China. Commercial banks must set their RMB deposit and lending rates pursuant to the ceiling and floor interest rates defined by the PBOC.⁶² Moreover, except for short-term loans, banks and other financial institutions are not allowed to decide how interests should be calculated, paid, or collected.⁶³

There is still a long way to go before interest rate control can be completely abolished. A World Bank survey lists five preconditions for the successful interest rate liberalization, *i.e.*, a financial sound real sector (in China, mainly SOEs); banks with positive net worth; bank management with high quality; high regulatory and supervisory standards; and a gradual process.⁶⁴ While China has made considerable progress in all these areas, the weak financial health of the State enterprise sector and the deteriorating quality of banks' assets, however, suggest that interest liberalization cannot be achieved in China quickly.⁶⁵

⁵⁷ See generally Xie, Ping, 'Toward a Market-Oriented Interest Rate Policy in the Transformation of China's Economy', in Mehran, Hassanali, Laurens, Bernard & Quintyn Marc (eds.), *Interest Rate Liberalization and Money Market Development*, 19 (1996).

⁵⁸ It is important to put deposit interest rates liberalization after the lending rates liberalization. Without a prior or simultaneous freeing of lending rates, freeing deposit rates would result in a substantial squeeze on bank margins, drastically reducing their already low level of profits.

⁵⁹ See, *e.g.*, Dai, Gengyou, *supra* note 10.

⁶⁰ See Chinaonline, 'Dai Xianglong: China to Adopt Market Interest Rates' (January 24, 2000), available at '<http://www.chinaonline.com/topstories/000124/C00012003.asp>'.

⁶¹ See, *e.g.*, Kynge, James, 'Beijing Move on Foreign Currency', *Fin. Times* (September 5, 2000).

⁶² The Commercial Banking Law, *supra* note 18, arts. 31 & 38.

⁶³ For details of how interests should be calculated, paid or collected, see the 1999 Interest Rate Administration Provisions, *supra* note 52, arts. 11-29.

⁶⁴ See generally the World Bank, *supra* note 13, Box 3.1.

⁶⁵ Dai Xianglong was reported to have predicted a three-year-period for decontrolling interest rate. See Kynge, James, 'China to Liberalize Rates Regime within Three Years', *Fin. Times* (July 19, 2000).

III. CURRENT BANKING REGULATION AND SUPERVISION IN CHINA: AS COMPARED WITH THE BASLE COMMITTEE CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

Banking regulation and banking supervision are closely connected with each other. Banking regulation can be defined as the establishment of rules, both acts of the legislator (the NPC and its Standing Committee in China), and statutory instruments or rules of the competent authorities (the State Council and its subordinated ministries, including the PBOC in China).⁶⁶ Banking supervision, according to Dr. Lastra,⁶⁷ in a broad sense can be defined as a process with four stages or phases: licensing, on-going supervision, sanctioning, and crisis management.⁶⁸ In other words, banking supervision is a process of enforcing banking regulations established by the legislator and other competent authorities. The licensing, on-going supervision, sanctioning and crisis management must be carried out according to rules established by the legislator and other competent authorities.

In this section, comments will be made on China's current banking regulation and supervision as compared with the Basle Committee Core Principles for Effective Banking Supervision.⁶⁹ Given the relationships between banking regulation and supervision, the discussion will be organized around different stages of banking supervision.

A. LICENSING PROCESS AND APPROVAL FOR CHANGES IN STRUCTURE

1. The Core Principles' Requirements

Sound licensing and structure requirements are an entry policy to protect safe and sound banking practices. They act as filters to prevent "bad" banks and dishonest people from

⁶⁶ See, e.g., Lastra, R. M., *Central Banking and Banking Regulation*, 108 (1996).

⁶⁷ *Id.*

⁶⁸ The crisis management, namely, the central bank's role of lender of last resort, a deposit insurance scheme, and bank insolvency proceedings, are to be discussed in Chapter Four.

⁶⁹ It has been a consensus that China should bring its bank regulations in line with international "best practices", especially the Basle Core Principles for Effective Banking Supervision. See, e.g., Burke, Michael E., IV, 'Improving China's Bank Regulation to Avoid the Asian Bank Contagion', 17 *UCLA Pac. Basin L. J.*, 32, 32 (Summer 1999); and also Meng, Long, 'The Basle Core Principles and China Financial Regulation and Supervision [baseer hexing yuanze yu zhongguo de jingrong jianguan]', *China Finance* No. 7, 14, at 14, 16 (1999).

entering the banking system.⁷⁰ The 2nd through the 5th Core Principles suggest minimum standards for the licensing and structure of banks. The Core Principles' first entry policy is a standard definition of those activities a "bank" may undertake,⁷¹ to be enforced through a licensing process overseen by a central regulator who uses objective standards in reviewing applications requiring the disclosure of the entity's organization, management, and operating plan.⁷² After granting the initial license, the regulator must be able to review a bank's transfer of control to a third party⁷³ and a bank's major acquisitions or investments to ensure that the bank is not exposed to undue risk through corporate relationships.⁷⁴

2. Licensing and Structure Change Approval in China

The criteria applied in China are similar to those applied in other countries. Under China's Commercial Banking Law, no organization or individual should receive money deposits from the public or do any other businesses of a commercial bank or use the title of "bank" without the approval of the PBOC.⁷⁵ The Law lists out the businesses a commercial bank may engage in with the authorization the PBOC.⁷⁶

There are five requirements to establishing a commercial bank:⁷⁷ (1) articles of association in conformity with the Commercial Banking Law and the Company Law; (2) minimum amount of registered capital;⁷⁸ (3) senior managerial personnel (including chairman of the board of directors (president) and general manager) with expertise and professional experience required by their positions;⁷⁹ (4) sound organizational and management structure;

⁷⁰ See generally Lastra, R. M., *supra* note 66, at 109-10.

⁷¹ Basle Committee, *Core Principles for Effective Banking Supervision* (September 1997), available at '<http://www.bis.org/publ/bdbs30a.htm>' (hereinafter referred to as "the Basle Core Principles"), principle 2.

⁷² *Id.* principle 3.

⁷³ *Id.* principle 4.

⁷⁴ *Id.* Principle 5.

⁷⁵ The Commercial Banking Law, *supra* note 18, art. 11.

⁷⁶ *Id.* art. 3.

⁷⁷ *Id.* art. 12.

⁷⁸ The minimum registered capital for the establishment of a commercial bank should be RMB1bn, for the establishment of an urban cooperative commercial bank should be RMB100m and for the establishment of a rural cooperative commercial bank RMB50m. *Id.* art. 13.

The registered capital should be paid-in capital. The PBOC may raise the floor amount of the registered capital for the establishment of a commercial bank in the light of economic development. *Id.*

⁷⁹ The Commercial Banking Law prohibits anyone who has one of the following backgrounds from holding high managerial positions in a commercial bank: (1) having once been sentenced to imprisonment or deprived of political rights on account of graft, bribery, illegal possession of property, embezzlement of public property or disruption of social economic order; (2) having served as a director of the board of directors, the director or

and (5) up-to-standard business site, safety measures and other facilities relevant to the business thereof. Appropriate documentation evidencing the foregoing must be filed with the PBOC.⁸⁰

Commercial banks in China are permitted to set up branches within or outside the territory of the PRC in keeping up with their business needs.⁸¹ Commercial banks, however, must apply to⁸² and obtain approval from the PBOC for setting up branches.⁸³ The total sum of the working capital to be allocated to all branches of a bank should not exceed sixty percent of the total capital of the commercial bank.⁸⁴

According to the Commercial Banking Law, any organization or individual intending to buy more than ten percent of the shares of a commercial bank should obtain the approval of the PBOC.⁸⁵

Chinese commercial banks are prohibited from engaging in trust investment or stock business, or investing in real estate not for its own use within the territory of the PRC.⁸⁶ Neither are they allowed to invest in non-bank financial institutions or enterprises within the

manager of a company which went bankrupt because of mismanagement and having been personally responsible for the bankruptcy; (3) having been the legal representative of a company whose business license had been revoked on account of violation of the law and having been personally responsible thereof; or (4) having failed to repay a fairly large debt already due. *Id.* art. 27.

⁸⁰ *Id.* arts. 14 & 15. According to these two articles, an applicant should supply to the PBOC for the establishment of a commercial bank (1) an application for the establishment of a commercial bank, specifying the name, location, registered capital and business scope of the bank thereof; (2) a feasibility study report; and (3) other documents and information required by the PBOC. After the PBOC's examination and approval of the preliminary application, the applicant should fill a formal application form and submit the following documents and information: (1) a draft of the statute of the commercial bank to be established; (2) qualification documents of the senior managerial staff to be employed; (3) a certificate of capital confirmation from a legitimate capital confirmation authority; (4) a list of the names, capital contributions and shares of the share holders of the commercial bank; (5) credit certificate and other relevant information of the share holders each holding more than ten percent of the registered capital of the commercial bank; (6) the guideline and plan for the operation of the commercial bank; (7) information of the business site, safety measures and other facilities relevant with the business of the commercial bank; and (8) other documents and information required by the PBOC.

⁸¹ *Id.* art. 19.

⁸² *Id.* art. 20, which reads as follows:

For the establishment of a branch, the applying commercial bank should submit the following documents and information: (1) an application for establishing a commercial bank branch, specifying the name, amount of working capital, business scope and the locations of the headquarters and branch of the commercial bank; (2) a financial report of the last two years of the applicant; (3) certificates of qualifications of the senior managerial officials to be appointed; (4) the business guideline and plan; (5) information related to the business site, safety measures and other facilities relevant with the business thereof; and (6) other documents and information required by the PBOC.

⁸³ *Id.* art. 19.

⁸⁴ *Id.*

⁸⁵ *Id.* art. 28.

⁸⁶ *Id.* art. 43.

territory of the PRC.⁸⁷ A commercial bank is allowed to invest into or acquire another commercial bank, subject to the approval of the PBOC, however.⁸⁸

To ensure that the PBOC monitor and supervise the structure changes of a bank, the Commercial Banking Law requires that a bank obtain the approval from the PBOC in the event of any of the changes in (1) name; (2) registered capital; (3) the business sites of the head office and/or branch(es); (4) business scope; (5) major shareholdings (shareholders, each holding more than 10% of the total capital or total shares of the bank); or (6) articles of association and other changes specified by the PBOC.⁸⁹ The law also requires that when a commercial bank needs to replace its chairman of the board of directors, or general manager with a new one, the qualifications of the appointee should be reported to the PBOC for examination.

3. Are China's Requirements in Conformity with the Basle Core Principles?

At the first look, China's practices in licensing and structure change approval comply with the Basle Core Principles requirements. There are problems with China's entry policy, however. While thorough, transparent, objective, and sound licensing policies are essential for an efficient and effective entry policy;⁹⁰ there is still a long way to go before China can achieve these standards. The five requirements to establishing a commercial bank set by the Commercial Banking Law need to be detailed and publicized. Efforts have been made these years to better define the five requirements. For example, better definitions of the professional knowledge and specialized work experience a banker should possess were given in the Interim Provisions on the Administration of Qualifications for Financial Institution Senior Management in 1996.⁹¹ These provisions, however, are PBOC's internal rules and not properly publicized. Besides, there are other issues, such as the types of operational facilities a bank should possess, that need to be specified. The lack of detailed requirements and the

⁸⁷ *Id.*

⁸⁸ *Id.* art. 25.

⁸⁹ *Id.* art. 24.

⁹⁰ See Folkerts-Landau, David & Lingdgren, Carl-Johan, *Toward a Framework for Financial Stability*, 32-6 (1998).

⁹¹ Interim Provisions on the Administration of Qualifications for Financial Institution Senior Management [jinrong jigou gaoji guanli ren yuan renzhi zhige guanli zhanxing guiding], issued by the PBOC on September 13, 1996.

lack of transparency give the PBOC too much discretion⁹² and allow for political interference.

B. ARRANGEMENTS FOR ONGOING BANKING SUPERVISION

Prudential regulation and supervision in the banking sector seeks four goals: (1) establishing procedures that allow only financially viable banks to operate; (2) limiting excessive risk-taking by bank owners and managers; (3) establishing appropriate accounting, reporting, and valuation rules; and (4) providing for corrective measures and restrictions on activities of weak institutions.⁹³ The achievement of these goals requires both prudential regulations setting standards for banks and on-going supervision to ensure that banks operate in compliance with these standards and to correct banks' failure to do so.

1. Prudential Regulations and Requirements

The Core Principles devote 10 out of the 25 Core Principles to setting standard prudential regulations that aims at effective risk-management:⁹⁴ capital adequacy- principle 6; credit risk management- principle 7 (credit-granting standards and credit monitoring process), principle 8 (assessment of asset quality and adequacy of loan loss provisions and reserves), principle 9 (concentrations of risk and large exposure), principle 10 (connected lending), and principle 11 (country and transfer risk); market risk management- principle 12; other risk management- principle 13; and internal controls- principles 14 , 15. China has implemented most of these standard prudential regulatory requirements.

Asset-liability ratio management requirements: In 1994, the PBOC issued a set of new prudential ratios in pilot form to guide the operations of banks and non-bank financial institutions.⁹⁵ The 1995 Commercial Banking Law legitimized the asset-liability ratio management requirements by providing that a commercial bank in its loan business should

⁹² Actually, the PBOC is granted discretion by the Commercial Banking Law. The law requires that the PBOC in examining the application for the establishment of a commercial bank should take into account the need for economic growth and the competition of the banking industry. The Commercial Banking Law, *supra* note 18, art. 12.

⁹³ See Folkerts-Landau, David & Lindgren, Carl-Johan, *supra* note 90, at 11.

⁹⁴ These risks includes but not limited to: credit risk, country and transfer risk, market risk, interest rate risk, liquidity risk, operational risk, legal risk, and reputation risk.

abide by the regulations on the asset-liability ratios as follows:⁹⁶ (1) the capital adequacy rate shall not fall short of 8%; (2) the ratio of the outstanding balance of loans to that of deposits shall not exceed 75%; (3) the ratio of liquid assets to liquid liabilities shall not fall short of 25%; (4) the ratio of loans to one borrower to the capital of the bank shall not exceed 10%; and (5) other stipulations by the PBOC on asset and liability management. On December 12, 1996, the PBOC issued Monitoring and Supervisory Indexes of Asset-Liability Ratio Management for Commercial Banks,⁹⁷ further specified the ratios set by the Commercial Banking Law and added new ratio management requirements to cover market risk and off-balance-sheet items.

Prohibitions on connected lending: Provisions are contained in the Commercial Banking Law prohibiting commercial banks from extending unsecured loans to related persons or providing related persons with secured loans on conditions more favorable than those to a borrower of a similar loan.⁹⁸

General Lending Rules: As for credit granting standards and credit monitoring process, the PBOC issued General Lending Rules in 1996.⁹⁹ The General Lending Rules contain 12 chapters providing rules on lending procedures, supervision on NPLs, lending responsibility system, protection of loan claim rights, and management of loan clearing-off.¹⁰⁰

Limitations on Foreign Exchange Exposure: What have been developed in the most detail might be limitations on foreign exchange exposure. In China, limitations on banks' foreign exchange exposure existed long before the Asian financial crisis, with the State

⁹⁵ See the 1994 PBOC Circular on Asset-Liability Management, *supra* note 15.

⁹⁶ The Commercial Banking Law, *supra* note 18, art. 39.

⁹⁷ Monitoring and Supervisory Indexes of Asset-Liability Ratio Management for Commercial Banks [shangye yinhang zhichan fuzhai bili guanli jiankong, jianche zhibiao], issued by the PBOC on December 12, 1996 and effective as of January 1, 1997 (hereinafter referred to as "Monitoring and Supervisory Indexes of Asset-Liability Ratio Management").

⁹⁸ The Commercial Banking Law, *supra* note 18, art. 40. Related persons in this article refer to: (1) the members of the board of directors, members of the board of supervisors, managerial personnel and staff of the credit department of a commercial bank, and their close relatives; and (2) the company, enterprise or other economic organization wherein the aforesaid persons have made investment or assumed senior managerial positions. *Id.*

⁹⁹ General Lending Rules [daikuan tongze], published by the PBOC on June 28, 1996 and effective as of August 1, 1996.

¹⁰⁰ The twelve chapters are: Chapter I (General Provisions), Chapter II (Categories of Loans), Chapter III (Terms of Loan and Interest Rates), Chapter IV (Borrower), Chapter V (Lender), Chapter VI (Loan Procedures), Chapter VII (Supervision on NPL), Chapter VIII (Loan Responsibility System), Chapter IX (Protection of Loan Claim Rights and Management of Loan Clearing-off), Chapter X (Special Regulations on Loan Management), Chapter XI (Penalties), and Chapter XII (Ancillary Provisions).

Administration of Foreign Exchange (SAFE)¹⁰¹ responsible for ensuring: (1) that all international commercial borrowing by domestic institutions is approved in advance, and (2) that borrowed amounts do not exceed certain multiples of borrowers' net assets and foreign exchange earnings. Limitations on banks foreign exchange exposure in China were enhanced in the wake of the Asian financial crisis by the adoption of new regulations.

According to these new regulations, the total value of guarantees overseas, guarantees of foreign exchange debts within China, and all foreign exchange-denominated debt of a bank or non-bank financial institution cannot exceed twenty times the value of its own foreign currency-denominated capital.¹⁰²

To measure more accurately and to discourage offshore borrowing by overseas subsidiaries or affiliates of Chinese firms and financial institutions, the regulations prohibit transferring for use in China proceeds from foreign currency-denominated bonds issued by foreign subsidiaries of Chinese financial institutions.¹⁰³ Advance approval is required for foreign currency commercial borrowing by overseas subsidiaries of Chinese financial institutions if the amount is US\$50m or more, and these funds may not be transferred into China without the approval of the SAFE.¹⁰⁴ Moreover, the new regulations require that foreign exchange deposits in Chinese banks by institutions and individuals outside China be "considered and managed as international commercial loans."¹⁰⁵

Internal Controls and Loan Classification: With regard to internal controls, the PBOC issued Guidelines for Enhancing Internal Controls of Financial Institutions on May 16, 1997.¹⁰⁶ Respecting loan classification, the PBOC issued Guidelines for Loan

¹⁰¹ The SAFE was established in 1980 as a department of the Bank of China by regulations issued by the State Council to regulate foreign exchange business. In 1983, the SAFE was placed under the jurisdiction of the PBOC. See Zheng, Henry R., *China's Civil and Commercial Law*, 87 & note 3 (1988).

¹⁰² Article 22, Detailed Rules of the SAFE for the Implementation of the Procedures for the Administration of Guarantees Overseas by Institutions in China, *Jingrong Shibao*, 2 (January 13, 1998), translated in *China Economic News*, 8-10 (March 9, 1998) and 6-9 (March 16, 1998).

¹⁰³ Administrative Procedures for the Issuances of Foreign Currency Bonds by Institutions in China, *Jingrong Shibao*, 2 (December 16, 1997), translated in *China Economic News*, 7-9 (February 9, 1998), 7-9 (February 16, 1998).

¹⁰⁴ Administrative Procedures for Borrowing International Commercial Loans by Institutions in China, arts. 30 & 31.

¹⁰⁵ *Id.* art. 2.

¹⁰⁶ Guidelines of the PBOC for Enhancing Internal Controls of Financial Institutions [zhongguo renmin yinhang jiaqiang jinrong jiguo neibu kongzhi de zhidao yuanze], issued by the PBOC on May 16, 1997 (hereinafter referred to as "the PBOC Guidelines for Enhancing Financial Institution Internal Controls").

Classification¹⁰⁷ in 1998 to introduce a new loan classification and provisioning system in consistency with international standards and Basle Committee recommendation (see Annex XII).

2. Methods of Ongoing Banking Supervision

(i) *General Introduction*

Ongoing banking supervision refers to the monitoring of the safety and soundness of a bank during its “healthy” life, by the oversight of banks’ compliance with prudential regulations and requirements.¹⁰⁸ Ongoing supervision is generally exercised by the public authorities through different measures and instruments including: reports, ratings, on-site examination, in-house surveillance, and consultations with high level management; complemented by reporting of independent external auditors.¹⁰⁹ It is recommended by the Basle Committee that banking supervisors have regular contact with bank management and a thorough understanding of the institution’s operations; that banks be required to submit information on a periodic basis for review by the supervisors, and supervisors be able to discuss with banks all significant issues and areas of their business; and that banking supervisors have the ability to carry out consolidated supervision over banking organizations.¹¹⁰

(ii) *On-site Examination and Off-site Surveillance in China*

With regards to methods of ongoing banking supervision, China has been making progress since the mid-1990s.

a. From Solely Relying on On-site Examination towards the Combination of On-site Examination and Off-site Surveillance

¹⁰⁷ Guidelines for Loan Classification (for trial implementation) [daikuan fengxian fenglei zhidao yuanze (shixing)], the PBOC Document No. 151 (1998). The Guidelines are accompanied by an Implementing Explanation.

¹⁰⁸ See, e.g., Lastra, R. M., *supra* note 66, at 110-1.

¹⁰⁹ *Id.*, at 111.

¹¹⁰ The Basle Core Principles, *supra* note 71, principles 16, 17, 18, 19 and 20.

For the last two decades, the PBOC in China mainly relied on on-site examination to collect information. The sole reliance on on-site examination satisfied the need when the focus of the PBOC was to ensure that banks (mostly State banks) operated in compliance with credit plans and other administrative provisions.¹¹¹ When the regulatory and supervisory focus shifted to commercial bank's risk management capacity and asset quality, however, the PBOC could no longer manage the supervisory task by solely relying on on-site examination. First, the PBOC does not have sufficient resources to carry out on-site examination over thousands of financial institutions. Second, because on-site examination is mainly *ex post* examination, it becomes hard for the PBOC to establish early warning systems against financial risks.¹¹²

Under the authorization of the Central Banking Law and Commercial Banking Law,¹¹³ the PBOC started to establish an on-going supervision system incorporating both on-site examination and off-site surveillance in 1995.¹¹⁴ On April 5, 1995, the PBOC issued Interim Provisions on Off-site Surveillance,¹¹⁵ providing that off-site surveillance should focus on (1) the risk management capacity and asset quality of financial institution; and (2) whether financial institutions operate in compliance with laws and administrative regulations.¹¹⁶ The combination of on-site examination and off-site surveillance makes it possible for the PBOC to concentrate its resources on problem institutions. Off-site surveillance helps the PBOC identify those risky banks and problems with a specific bank so

¹¹¹ The 1994 Provisions on Financial Institution Administration [jinrong jigou guanli guiding], (promulgated by the PBOC on August 5, 1994), for example, does not distinguish between on-site examinations and off-site surveillance. Under the Provisions, the PBOC and its branches have the power to conduct annual examination over financial institutions and conduct examination over financial institutions at any time (art. 45) to ensure that financial institutions: (1) have gone through all necessary application and approval procedures for establishment and alternation; (2) have presented to the PBOC true information and materials; (3) have adequate and true registered capital; (4) operate within their authorized business scopes; (5) have gone through all necessary procedures to change their legal representatives and other senior management personnel; (6) have conducted their businesses in compliance with laws and regulations; (7) have good financial condition; and (8) have operational sites and security facilities satisfying relevant requirements (art. 47).

¹¹² See, e.g., Liu, Zhangjun & Liu, Xiaoyong, 'Enhance Risk-prevention, Promote the Off-site Surveillance System in China [jiaqiang fengxian fangfang, jiji tuijin woguo yinhangye feixianchang jianguan tixi jianshe]' in *Handbook of Off-site Surveillance for Commercial Banks [shangye yinhang feixianchang jianguan gongzhuo shuochu]* 1, at 4 (China Finance Press, 1999).

¹¹³ The Central Banking Law, *supra* note 2, arts. 32 & 33; the Commercial Banking Law, *supra* note 18, arts. 61 & 62.

¹¹⁴ See, e.g., Liu, Zhangjun & Liu, Xiaoyong, *supra* note 112, at 1.

¹¹⁵ Circular of the PBOC on Issuing Interim Provisions on Off-site Surveillance [zhongguo renmin yinhang guanyu yinfa feixianchang jihe jiandu zhanxing guiding de tongzhi], issued by the PBOC on April 5, 1995.

¹¹⁶ Interim Provisions on Off-site Surveillance, issued by the PBOC on April 5, 1995, arts. 9, 10.

that the PBOC can direct on-site examination against them. This allows the PBOC to carry out on-site examination more efficiently and effectively.¹¹⁷

b. Establishing Standards for On-site Examination and Off-site Surveillance

Bank supervisors must be able to identify potential problems via on-going supervision, thereby providing detection and promoting corrective action before problems become more serious. To achieve this, a rating system must be established for bank supervisors to analyze the information collected via on-site examination and off-site surveillance and to determine the financial condition of a bank. The CAMEL system employed by the US supervisors¹¹⁸ is a good example of such a rating system.

The PBOC has endeavored to establish its own rating system since it shifted its regulatory and supervisory focus to commercial bank's risk management capacity and asset quality. On December 12, 1996, the PBOC issued Monitoring and Supervisory Indexes of Asset-Liability Ratio Management for Commercial Banks,¹¹⁹ providing a basis for the PBOC to collect and analyze information from commercial banks.¹²⁰

c. Establishing and Improving the Reporting System

A reporting system is essential to the success of off-site surveillance. Banks worldwide are required to submit financial statements to their supervisors on a monthly, quarterly or annual basis. Though reports vary depending on the financial structure of each country and the size of the institution, they should generally include a report of condition (balance-sheets on a consolidated basis including subsidiaries), a report of income and dividends, a report of international operations and foreign exchange exposures, a report on past due loans and NPLs, a report on ownership of the reporting bank, and a report on off-balance sheet activities.¹²¹

¹¹⁷ See, e.g., Liu, Zhangjun & Liu, Xiaoyong, *supra* note 112, at 4-5.

¹¹⁸ CAMEL was developed by the Federal Reserve System (FRS) and the Office of Currency Comptroller (OCC) to rate the financial performance of banks in the US. It is formally called the Uniform Financial Institutions Rating System and was originally developed in 1978-9.

¹¹⁹ Monitoring and Supervisory Indexes of Asset-Liability Ratio Management, *supra* note 97.

¹²⁰ The indexes consist of 16 categories, including most of those required by the CAMEL system.

¹²¹ See Lastra, R. M., *supra* note 66, at 111.

The PBOC in China is authorized by the Central Banking Law to “demand financial institutions to submit balance sheets, statements of profits and loss, and other financial accounting reports and material in pursuance of regulations.”¹²² To consummate the reporting system, on March 6, 1996, the PBOC issued a Circular on Collecting Financial Statements from Banks for Supervisory Purpose.¹²³ Accordingly, banks should submit to the PBOC on a consolidated basis (1) a report of financial condition (attached with monthly accounting record, balance sheet, loss and profit report, *etc.*); (2) a report on the asset-quality; and (3) a report on the asset-liability ratio management. A bank with both RMB and foreign currency business must make a report on local currency business, a report on foreign currency business, as well as a report on the consolidated basis.¹²⁴ The Circular further provides for the frequency of reporting.¹²⁵ On January 1, 1997, the Monitoring and Supervisory Indexes of Asset-Liability Ratio Management for Commercial Banks¹²⁶ came into effect. Banks were required to report to the PBOC under the new indexing system.¹²⁷ On December 16, 1997, the PBOC issued Forms of Off-site Surveillance Reports for Commercial Banks and Their Description¹²⁸ to unify the reporting contents and their forms.

The unification of the reporting contents and their forms created conditions for computerizing the collection of information and materials from commercial banks. Since the first quarter of 1998, the PBOC has started to receive electronic reports from commercial banks.¹²⁹ There are plans to computerize the whole process of off-site surveillance.¹³⁰

d. Consolidating On-going Supervision

¹²² The Central Banking Law, *supra* note 2, art. 33. This is supplemented by the Commercial Banking Law, which provides that a commercial bank should periodically submit to the PBOC balance sheets, profit and loss statements, and other financial statements and information. The Commercial Banking Law, *supra* note 18, art. 61.

¹²³ Circular of the PBOC on Collecting Financial Statements from Banks for Supervisory Purpose [zhongguo renmin yinhang guanyu yinhangye jianguan baobiao shixing zhuangshou zhidu de tongzhi], issued by the PBOC on March 6, 1996.

¹²⁴ *Id.* art. 2.

¹²⁵ *Id.* art. 3.

¹²⁶ Monitoring and Supervisory Indexes of Asset-Liability Ratio Management, *supra* note 97.

¹²⁷ See Liu, Zhangjun & Liu, Xiaoyong, *supra* note 112, at 11.

¹²⁸ Circular of the PBOC on Issuing Forms of Off-site Surveillance Reports for Commercial Banks and Their Description [zhongguo renmin yinhang guanyu yinfa shangye yinhang feixianchang jianguan zhibiao baobiao tianbao shouming he shangye yinhang feixianchang jianguan baobiao baogaoshu de tongzhi], issued by the PBOC on December 16, 1997 and effective as of January 1, 1998.

¹²⁹ See Liu, Zhangjun & Liu, Xiaoyong, *supra* note 112, at 11.

An essential element of banking supervision is the ability of the supervisors to supervise the consolidated banking organization.¹³¹ This includes the ability to review both banking and non-banking activities conducted by the banking organization, either directly or indirectly (through subsidiaries and affiliates), and activities conducted at both domestic and foreign offices. In all cases, the banking supervisors should be aware of the overall structure of the banking organization or group when applying their supervisory methods.¹³²

In 1994, the PBOC issued a set of new prudential ratios in pilot form to guide the operations of banks and non-bank financial institutions.¹³³ These ratios were applicable to a bank as a whole, including its headquarters and branches, and its subsidiaries.¹³⁴ In its 1996 Monitoring and Supervisory Indexes of Asset-Liability Ratio Management for Commercial Banks, the PBOC requires banks to apply asset-liability ratio management requirements to their foreign currency operations, as well as overseas operations and/or off-balance sheet operations.¹³⁵

(iii) *Problems with China's Ongoing Supervision and Recommended Solutions*

a. Developing Clear Rules for On-site Examination

On-site examinations are a means by which supervisors obtain information *in situs* on the financial condition of an institution, and its compliance with the law.¹³⁶ On-site examination and/or use of external auditors are necessary because they provide supervisors with means of validating information reported by banks.¹³⁷

¹³⁰ *Id.*

¹³¹ The Basle Core Principles, *supra* note 71, principle 20.

¹³² The Basle Committee recommended supervision on a consolidated basis in its paper 'Consolidated Supervision of Banks' International Activities'.

¹³³ The 1994 PBOC Circular on Asset-Liability Management, *supra* note 15.

¹³⁴ *Id.* art. 5.

¹³⁵ Monitoring and Supervisory Indexes of Asset-Liability Ratio Management, *supra* note 97.

¹³⁶ See Lastra, R. M., *supra* note 66, at 115.

¹³⁷ On-site examinations provide the supervisor with a means of verifying or assessing a range of matters including: (1) the accuracy of reports received from the bank; (2) the overall operations and condition of the bank; (3) the adequacy of the bank's risk management systems and internal control procedures; (4) the quality of loan portfolio and adequacy of loan loss provisions and reserves; (5) the adequacy of accounting and management information systems; (6) issues identified in off-site or previous on-site supervisory processes; and (7) bank adherence to laws and regulations and the terms stipulated in the banking license.

The provisions concerning on-site examination are very rough in China. According to article 32 of the Central Banking Law, the PBOC may audit, check, and supervise at any time the deposits, credits, settlements, bad loans, and other business affairs of a financial institution; and to check and supervise the raising or lowering of interest rates on deposits or loans by financial institutions in violation of regulations.¹³⁸ The PBOC personnel in charge of the examination and supervision is required to produce legitimate certificates at the time of conducting examination and supervision.¹³⁹

The roughness of rules for on-site examination makes on-site examination in China purely *ex post* supervision and punishments. Instead of identifying problems and providing early warning signals, on-site examiners in China work mainly as “firemen”. It is therefore important that the supervisory agency should establish clear internal guidelines on the frequency and scope of the examination. In addition, examination policies and procedures should be developed to ensure that the examination is carried out in a thorough and consistent manner with clear objectives.

b. Making Full Use of Independent External Auditors¹⁴⁰

The report of external auditor is an important complement to the supervisory devices. The participation of specialized firms can help achieve greater transparency in the conduct of the banking business.¹⁴¹ In some countries, such as the UK, a professional duty was imposed on the statutory auditors of firms in the regulated financial sector (banks, building societies, financial-service firms, insurance companies, and friendly societies) to report to the competent supervisory authorities any irregularities or matters raising material prudential

¹³⁸ See also the Commercial Banking Law, *supra* note 18, art. 62.

¹³⁹ *Id.* art. 62.

¹⁴⁰ A distinction must be made here between the public auditing of State-owned financial institutions and independent external auditors. According to the Audit Law of the PRC, State audit institutions should exercise supervision through auditing over the assets, liabilities, profits and losses of the State-owned financial institutions (art. 19). Actually, the PBOC's banking supervision over State commercial banks is supplemented by the State Auditing Bureau, which helped identifying irregularities of State commercial banks. The 2000 State Auditing Bureau's audit of the ICBC and the CCB, for example, found that these institutions' illegal operations have cost the national treasury more than RMB10bn in losses. See Chinaonline, 'Auditor: ICBC, CCB's Illegal Operations Cost China US\$1.2b' (July 11, 2000), available at '<http://www.chinaonline.com/topstories/000711/1/C00070612.asp>'.

The State Auditing Bureau, however, because of its limited resources, cannot play a regular role of external audits, although the Commercial Banking Law does subject commercial banks to the audit control by the auditing authorities. The Commercial Banking Law, *supra* note 18, art. 63.

concerns of which they have become aware.¹⁴² A similar obligation has been imposed at the European level with the final adoption of the Directive on the Reinforcement of Prudential Supervision (the so-called 'Post-BCCI' Directive).¹⁴³

Ideally, the PBOC should mainly rely on its own resources to carry out on-going supervision. In this way the PBOC can identify problematic institutions and problems with a specific bank quickly and directly so that the problem can be solved in a timely manner. On-going supervision, especially on-site examination, however, requires a large number of experienced bank examiners, while training a bank examiner is costly and time-consuming.¹⁴⁴ It is therefore necessary for the PBOC to rely at least partially on independent external auditors.¹⁴⁵

The external audit for banks started in 1994 with foreign-invested banks in China.¹⁴⁶ According to Provisions Concerning External Audit of Foreign-Invested Financial Institutions,¹⁴⁷ a foreign-invested financial institution (FIFI) should retain external auditors approved by the local PBOC branch to audit its annual financial reports.¹⁴⁸ The retained auditors should audit and make recommendations on the FIFI's (1) assets, liabilities, profits and losses, and asset quality; (2) financial statements that the FIFI is to submit to the PBOC; (3) internal controls; (4) computer system; and (5) asset-liability ratio management situation.¹⁴⁹ External auditors should produce a report after the auditing of a FIFI, pointing

¹⁴¹ See Lastra, R. M., *supra* note 66, at 120.

¹⁴² UK: Accountants (Banking Act 1987) Regulations 1994, SI 1994/524; Building Societies (Auditors) Order 1994, SI 1994/525; Auditors (Financial Services Act 1986) Rules 1994, SI 1994/526; Auditors (Insurance Companies Act 1982) Regulations 1994, SI 1994/449; Friendly Societies (Auditors) Order 1994, SI 1994/132.

¹⁴³ European Parliament and Council Directive 95/26/EC of 29 June 1995, OJ 1995 L168/7, 18 July 1995, art. 5.

¹⁴⁴ It takes four to five years for an examiner just to learn the skills necessary to examine small, well-managed institutions. Also, recruitment of bank supervisory staff is in competition with the private sector where the compensation is greater. See, e.g., Polizatto, V. P., 'Prudential Regulation and Banking Supervision' in Vittas, Dimitri (ed.), *Financial Regulation: Changing the Rules of the Game*, 310 (1992).

¹⁴⁵ See, e.g., Fan, Qixing, Wu, Yuyun & Yang Lixin, 'Necessity to Improve External Auditing of Commercial Banks [shangye yinhang waibu shenji jidai wanshan]', *China Finance* No. 4, 42 (April 2000).

¹⁴⁶ Regulations of the People's Republic of China on the Administration of Foreign-invested Financial Institutions [zhonghua renmin gonghe guo waizi jinrong jigou guanli tiaoli], issued by the State Council on February 25, 1994 and effective as of April 1, 1994. The Regulations requires a foreign-invested financial institution to retain PRC CPAs approved by the local PBOC branches. *Id.* art. 34.

¹⁴⁷ Provisions Concerning External Audit of Foreign-Invested Financial Institutions [weituo zhuche kuijishi dui waizi jinrong jigou jingxing shenji de guiding], issued by the State Council as an appendix to Regulations of the People's Republic of China on the Administration of Foreign-invested Financial Institutions.

¹⁴⁸ *Id.* arts. 1 & 2.

¹⁴⁹ *Id.* art. 2.

out problems with the audited institution.¹⁵⁰ FIFIs are required to submit the external auditors' report to the local PBOC branch in 3 months after each financial year. Local PBOC branches may require external auditors to make explanation about certain problems identified in the report; and, if necessary, demand audits of specific issues.¹⁵¹

In 1999, the PBOC issued Guidelines on External Audit for Foreign-Invested Banks.¹⁵² The Guidelines are similar to the Provisions Concerning External Audit of Foreign-Invested Financial Institutions, except that accountants are now required to audit a foreign-invested bank in accordance with newly issued prudential regulations¹⁵³ such as Guidelines for Loan Classification (1998 No. 151), Monitoring and Supervisory Indexes of Asset-Liability Ratio Management for Commercial Banks,¹⁵⁴ Guidelines of the PBOC for Enhancing Internal Controls of Financial Institutions,¹⁵⁵ and the Basle Committee Framework for Internal Control systems in Banking Organizations.¹⁵⁶ The Guidelines on External Audit for Foreign-Invested Banks actually make reporting from independent external auditors part of the PBOC's on-going supervision on foreign-invested banks in China.

External audit on State commercial banks, joint stock commercial banks, and city commercial banks, however, has not developed fully in China,¹⁵⁷ despite the provisions of the Commercial Banking Law that a commercial bank should announce its business performance and audited statement of the previous fiscal year¹⁵⁸ within three months after the end of every fiscal year.¹⁵⁹ On March 15, 1996, the PBOC recommended more than 70 accounting firms to commercial banks and non-bank financial institutions.¹⁶⁰ Accordingly, financial institutions

¹⁵⁰ *Id.* art. 3.

¹⁵¹ *Id.* art. 4.

¹⁵² Guidelines on External Audit for Foreign-Invested Banks [waizi yinhang waibu shenji zhidao yijian], issued by the PBOC in May 1999.

¹⁵³ *Id.* art. 5.

¹⁵⁴ Monitoring and Supervisory Indexes of Asset-Liability Ratio Management For Commercial Banks [shangye yinhang zhichan fuzhai bili guanli jiankong, jianche zhibiao], issued by the PBOC on December 12, 1996 and effective as of January 1, 1997.

¹⁵⁵ The PBOC Guidelines for Enhancing Financial Institution Internal Controls, *supra* note 106.

¹⁵⁶ Basle Committee, *Framework for Internal Control Systems in Banking Organizations* (September 1998), available at '<http://www.bis.org/publ/bcbs40.htm>' (hereinafter referred to as "the Basle Framework on Internal Controls").

¹⁵⁷ See, e.g., Fan, Qixing, Wu, Yuyun & Yang Lixin, *supra* note 145, at 42.

¹⁵⁸ The fiscal year of a commercial bank begins on the first of January and ends on the thirty-first of December of the Gregorian Calendar. The Commercial Banking Law, *supra* note 18, art. 58.

¹⁵⁹ *Id.* art. 56.

¹⁶⁰ Circular of the PBOC on Issues Concerning Recommended Accounting Firms [zhongguo renmin yinhang guanyu tongyi tuijian kuiji (shenji) shi shiwushuo youguan wenti de tongzhi], issued by the PBOC on March 15, 1996.

may retain one of these recommended accounting firms to verify their registered capital and total capital, to examine the qualification of investors, and to audit their annual financial reports. The PBOC examines and approves the establishment and alternation of a financial institution on the basis of reports by these accounting firms. These reports are also a basis for the PBOC's supervision over financial institutions.¹⁶¹

The PBOC, however, has not adopted any administrative measures or guidelines on the external audit of financial institutions other than FIFIs. So far, very few city commercial banks or joint stock commercial banks retain accounting firms to conduct external audit.¹⁶² To promote external auditing of domestic banks, it is necessary that the PBOC formulate administrative measures and guidelines on the external audit of domestic commercial banks. Besides, special training programs should be run so that accountants can have sufficient knowledge to audit commercial banks, to discover problems, and to report to the PBOC.¹⁶³ A mechanism should be put in place to facilitate discussions between the PBOC and external auditors. In many instances, these discussions should also include bankers.¹⁶⁴

It is worthwhile to point out here, however, that external auditors cannot replace supervisors: They have different responsibilities and are accountable to different groups.¹⁶⁵ In all cases, the supervisory agency should have the legal authority and means to conduct independent checks of banks based on identified concerns.

c. Developing Consultations between the PBOC and Bank Senior Management

Consultations with the bank senior management are a friendly form of supervision, in contrast to the most intrusive way of monitoring banks by on-site examination. As such, it is preferred in countries where the supervisory system is based on trust, in the UK for instance.¹⁶⁶ Consultations with senior management are time and cost saving compared to on-site examinations, because it is possible that banking supervisors consult with senior

¹⁶¹ *Id.* art. 1.

¹⁶² *See, e.g.,* Fan, Qixing, Wu, Yuyun & Yang Lixin, *supra* note 145.

¹⁶³ *Id.*

¹⁶⁴ The Basle Committee has reviewed the relationship between bank supervisors and external auditors and has developed best practices with regard to their interaction with external auditors. *See* "The Relationship between Bank Supervisors and External Auditors" — Volume III of the Compendium.

¹⁶⁵ *See* Lastra, R. M., *supra* note 66, at 120. While supervisors work for the government, auditors work for the institutions that they audit and have an interest "in keeping things going" to earn their fees. *Id.*

¹⁶⁶ *Id.*, at 118.

management of several banks at once. The author believes that consultations can be developed between the headquarters of the PBOC and headquarters of commercial banks, and between the local PBOC branches and commercial bank branches. Bank supervisors should be able to identify some problems and try to find out solutions to these problems via consultations with bank senior management.

d. Developing a Rating System Similar to the CAMEL System so as to Establish Early Warning Systems

The purpose of on-going supervision is to monitor the safety and soundness of a bank during its “healthy” life. This purpose cannot be achieved without an efficient early warning system (EWS) based on an effective rating system. An EWS can be designed for a whole financial system or for individual banks. The EWS of a financial crisis is economic variables, financial ratios and accounting measures that predict a bank panic or a financial crisis. A bank specific EWS is conducted by examining the business and performance of each individual bank. As mentioned before, China has developed standards for on-going banking supervision. These standards, however, are by no means as advanced as the CAMEL system in the US.

The CAMEL system comprises two principal elements. First, an assessment is made of five critical aspects of a bank’s financial condition: Capital adequacy, Asset Quality, Management, Earnings, and Liquidity (thus, the acronym CAMEL), which are rated on a scale of 1 through 5, with 1 being the most favorable. The second element combines the five factor ratings into a composite rating.¹⁶⁷ Composite rating 1 indicates a sound institution. Composite rating 2 indicates a fundamentally sound institution with modest weaknesses that can be corrected in the normal course of business. Composite rating 3 indicates a combination of weaknesses ranging from moderately severe to unsatisfactory. Composite rating 4 indicates an immoderate volume of asset weaknesses, or a less than satisfactory combination of other conditions. Composite rating 5 indicates that corrective action and constant supervisory attention are necessary.¹⁶⁸ The CAMEL is considered an international guideline for bank supervision and has been adopted by banking supervisors worldwide. In

¹⁶⁷ *Id.*, at 113-114.

¹⁶⁸ *Id.*, at 114 & note 194.

Canada, for example, it has been developed into CAMELOT by adding the quality of Operations and Treasury management into CAMEL.¹⁶⁹

It is necessary that a similar rating system be developed in China so that the PBOC can determine the soundness of individual banks by analyzing the collected information and rectifying the problems in the bank promptly. It might be unrealistic for the PBOC to develop a rating system as advanced as the CAMEL right away. The PBOC, however, can at least set minimum requirements and carry regulatory actions against these banks that cannot reach the minimum requirements.

C. SANCTIONING: FORMAL POWERS OF SUPERVISORS

Despite the efforts of supervisors, situations can occur where banks fail to meet supervisory requirements or where their solvency comes into question. In order to protect depositors and creditors, and to prevent more widespread contagion of such problems, supervisors must be able to conduct appropriate intervention. For this purpose, banking supervisors must have at their disposal adequate supervisory measures to bring about timely corrective action and to enable a graduated response by supervisors depending on the nature of the problems detected.¹⁷⁰

1. China Has Developed a Set of Supervisory Measures to Bring about Prompt Corrective Action (PCA)

China has developed an array of weapons to enforce banking laws and punish violations once detected. These mechanisms include “cease-and-desist” orders, civil penalties, administrative penalties, criminal penalties and others, with the revocation of a bank’s license as the ultimate sanction.

Under article 74 of the Commercial Banking Law, for example, when a commercial bank extends unsecured loans to related persons or extends loans against a collateral on more favorable conditions than to other borrowers of similar loans, the PBOC may order the

¹⁶⁹ This CAMELOT was developed by the Canadian Office of Superintendent of Financial Institutions. See Andrew, Sheng, ‘Resolution and Reform: Supervisory Remedies for Problem Banks’ in Andrew, Sheng (ed.), *Bank Restructuring: Lessons from the 1980s*, 51 (1996).

commercial bank to make corrections (cease-and-desist), confiscate the illegitimate gains if there is any, and mete out a fine ranging from one to five times the amount of the illegitimate gains; or, if there is no illegitimate gains, mete out a fine ranging from RMB100000 to 500000 (administrative penalties); if the case is particularly serious or the offender fails to make correction within the specified time, the PBOC may order it to suspend business and make rectification and consolidation, or revoke its banking permit.¹⁷¹ If the case constitutes a crime, the commercial banks and the responsible persons will be investigated for criminal responsibilities according to article 186 of China's Criminal Law¹⁷² (criminal penalties).

According to art. 73 of the Commercial Banking Law, a commercial bank that delays or refuses repayment of the principal and interests of a deposit with no proper reason should assume the responsibility of paying interests accrued and other civil responsibilities of compensation for damages to the property of depositors (civil liabilities).

On February 22, 1999, the State Council adopted Regulations Concerning the Punishment of Irregular Financial Activities,¹⁷³ consummating the supervisory measures to bring about PCAs.

2. Problems with China's PCAs and Improvement Recommendations

Unlike PCAs in developed countries, such as that in the US, where a gradation of sanctions linking the supervisory intensity with rating are designed to provide incentives for financial institutions to correct their operations in times of deteriorating ratings, in order to achieve business performance that accords to the safety and soundness standards of each banking regulators (see Annex XIII), sanctions in China are mainly designed to ensure that commercial banks operate in compliance with laws and administrative regulations. Looking through Chapter 8 of the Commercial Banking Law¹⁷⁴ and the Regulations Concerning the Punishment of Irregular Financial Activities, only art. 75 of the Commercial Banking Law and art. 21 of the Regulations Concerning the Punishment of Irregular Financial Activities

¹⁷⁰ The Basle Core Principles, *supra* note 71, principle 22.

¹⁷¹ The Commercial Banking Law, *supra* note 18, art. 74.

¹⁷² The Criminal Law of the People's Republic of China [zhonghua renming gongheguo xingfa], adopted at the Second Session of the 5th NPC on July 1, 1979, revised at the 5th Session of the 8th NPC on March 14, 1997.

¹⁷³ Regulations Concerning the Punishment of Irregular Financial Activities, issued by the State Council on February 22, 1999.

¹⁷⁴ The Commercial Banking Law, *supra* note 18, arts. 73-86 (Chapter 8: Legal Liabilities).

provide for sanctions against commercial banks' breach of asset-liability ratio management requirements.¹⁷⁵ The sanctions, from the author's point view, are mainly *ex post* punishment rather than incentives for banks to correct their operations.

It is therefore necessary for China to redesign its sanctions and PCAs. A system similar to that of the Federal Deposit Insurance Corporation Improvement Act 1991 should be developed in China, under which, the PBOC should have the authority not only to restrict the current activities of the bank but also to withhold approval for new activities or acquisitions. It should also have the authority to restrict or suspend dividends or other payment to shareholders, as well as to restrict asset transfers and a bank's purchase of its own shares. The PBOC should have effective means to address management problems, including the power to have controlling owners, directors, and managers replaced or their power restricted, and where appropriate, to bar individuals from the business of banking.

IV. PROMOTING INTERNAL CONTROL SYSTEMS WITHIN COMMERCIAL BANKS

A. THE BASLE COMMITTEE FRAMEWORK FOR INTERNAL CONTROL SYSTEMS IN BANKING ORGANIZATION

Internal controls are systems established to provide reasonable assurance of effective and efficient operations, reliable financial information and reporting, and compliance with laws and regulations.¹⁷⁶ A bank's internal controls can ensure the capital adequacy and minimize the market, transfer, and credit risks, and, by extension, secure the health of a banking system.

¹⁷⁵ *Id.* art. 75, which provides that when a commercial bank fails to abide by the stipulation on capital adequacy, the ratio between deposit and credit, the liquidity ratio, large exposure limitation, and other rules regarding asset-liability ratio management stipulated by the PBOC, the PBOC may order the commercial bank to make corrections, confiscate the illegitimate gains if there is any, and mete out a fine ranging from one to three times the amount of the illegitimate gain; or, if there is no illegitimate gains, mete out a fine ranging from RMB50000 to 300000. *See also* Regulations Concerning the Punishment of Irregular Financial Activities, *supra* note 173, art. 21.

¹⁷⁶ *See, e.g.,* Kinsella, Ray (ed.), *Internal Controls in Banking*, 1 (1995).

The importance of internal controls has been widely recognized, especially after the textbook case of the Bank of Credit and Commerce International (BCCI) collapse.¹⁷⁷ William J. McDonough, Chairman of the Basle Committee and President of the Federal Reserve Bank of New York, stated that “the Basle committee has been focusing on ways of strengthening internal controls at banks in recognition of the fact that internal control deficiencies continue to be a source of major problems and significant losses for banks globally.”¹⁷⁸

The Basle Committee devotes two of its 25 Core Principles for Effective Banking Supervision to bank internal controls. Principle 14 requires that banks have in place internal controls that are adequate for the nature and scale of their business. Principle 15 requires that banks have adequate policies, practices and procedures in place, including strict “know-your-customer” rules, that promote high ethical and professional standards in the financial sector and prevent banks from being used, intentionally or unintentionally, by criminal elements.

In September 1998, the Basle Committee issued a Framework for Internal Control Systems in Banking Organization¹⁷⁹ (hereinafter referred to as Internal Control Paper). In the Internal Control Paper, the Basle Committee establishes thirteen principles around five internal control elements for bank supervisors to apply in assessing the effectiveness of banks’ internal control systems, and for banks to develop their internal control processes and procedures. The five internal control elements identified by the Basle Committee are: (1) management oversight and control culture; (2) risk recognition and assessment; (3) control activities and segregation of duties; (4) information and communication; and (5) monitoring activities and correcting deficiencies.¹⁸⁰

B. THE DEVELOPMENT OF BANK INTERNAL CONTROLS IN CHINA

¹⁷⁷ It is concluded that the BCCI collapse shows how, in the absence of effective internal controls and compliance “culture”, fraud and dissimulation will inevitably flourish. See, e.g., Mogg, John F., ‘Internal Controls: The EC Response to BCCI’, in Kinsella, Ray (ed.), *Internal Controls in Banking* (1995).

¹⁷⁸ Basle Committee, *The Basle Committee Issues a Framework for Internal Control Systems in Banking Organization*, Press Release (September 22, 1998), available at ‘<http://www.bis.org/press/p980922a.htm>’.

¹⁷⁹ The Basle Framework for Internal Controls, *supra* note 156.

¹⁸⁰ The Internal Control Paper reacts to supervisory lessons learned from internal control failures that jeopardize the safety and soundness of global banking system. The Basle Committee groups the types of control breakdowns typically seen in problem bank cases into five categories and therefore identified five internal control elements.

1. Bank Internal Controls before the Issuance of the PBOC Guidelines for Enhancing Internal Controls of Financial Institutions

Chinese banks started to develop their internal controls only recently. Commercial banks in Shenzhen Special Economic Zone initiated the trial of asset-liability ratio management at the end of the 1980s. In the early 1990s, the CCB implemented the separation between the approval and the issuance of loans; the Merchant Bank carried out credit responsibility system¹⁸¹ and credit authorization system;¹⁸² and the ICBC issued “Ten Prohibited Activities in Banking Operation and Management”.¹⁸³

The Commercial Banking Law sets rules for bank internal controls by providing that a commercial bank should exercise self-regulating mechanism on the principle of economic efficiency, safety, and liquidity.¹⁸⁴ The Law provides that the Company Law of the PRC is applicable to the form and structure of the organization of a commercial bank.¹⁸⁵ Besides, commercial banks are required to formulate business rules, and to establish and improve their business management, the system of cash control, and their security system in accordance with the stipulations of the PBOC.¹⁸⁶ They are also required to establish and improve the systems of examining and checking deposits, loans, settlements, bad and doubtful accounts, and other business activities;¹⁸⁷ and to conduct regular examination and checks on their branches.¹⁸⁸

In spite of these efforts, the internal controls developed by commercial banks in China during that stage were very rough and manifested a lot of deficiencies. First, the internal auditing system within a commercial bank was not independent and did not have sufficient authorities and resources to carry out efficient, effective internal examinations and checks. Second, there was no clear division of responsibilities among different departments within a bank. Third, there was no efficient and effective accounting control. Fourth, the personnel

¹⁸¹ Under the credit responsibility system, those who approve or issue the loans should take personal responsibilities to the repayment of the loans.

¹⁸² Under the credit authorization system, the headquarters of the bank set credit ceilings for its branches and clients.

¹⁸³ The discussion in this paragraph draw heavily from Kang, Shusheng, *Commercial Banks' Internal Controls: Borrowing and Innovation*, 52 (1999).

¹⁸⁴ The Commercial Banking Law, *supra* note 18, art. 4.

¹⁸⁵ *Id.* art. 17.

¹⁸⁶ *Id.* art. 59.

¹⁸⁷ *Id.* art. 60.

¹⁸⁸ *Id.* art. 60.

management system could not satisfy the need of risk-control. There was no training system for bank staff. Fifth, there were no effective internal controls for newly emerged activities such as off-balance-sheet operations.¹⁸⁹

2. The 1997 PBOC Guidelines for Enhancing Internal Controls of Financial Institutions: in Comparison with the Basle Committee Internal Control Paper

To enhance internal controls in Chinese financial institutions, the PBOC issued Guidelines for Enhancing Internal Controls of Financial Institutions¹⁹⁰ in 1997. The Guidelines contain 32 articles in six chapters, governing internal controls of commercial banks and non-bank financial institutions.¹⁹¹

(i) *Definition and Objectives of Internal Controls*

The Guidelines define internal controls as a self-regulating mechanism for a financial institution, which consists of measures, methods, and procedures to ensure the accomplishment of established targets, to avoid and mitigate financial risks, and to provide efficient controls on internal departments and staff against the risks involved in the performance of their duties.¹⁹² The Guidelines set three objectives for internal controls of financial institutions: to ensure the implementation of laws, administrative regulations, and the PBOC rules,¹⁹³ to ensure efficient controls of risks involved in an institution's business, and to ensure the full accomplishment of development policies and strategies of an institution.¹⁹⁴

The definition and objectives provided by the PBOC Guidelines are similar to that of the Basle Committee Internal Control Paper. According to the Basle Committee, internal control is a process effected by the board of directors, senior management and all levels of personnel. It is not solely a procedure or policy that is performed at a certain point of time,

¹⁸⁹ See generally Kang, Shusheng, *supra* note 183, at 52-3.

¹⁹⁰ The PBOC Guidelines for Enhancing Financial Institution Internal Controls, *supra* note 106.

¹⁹¹ *Id.* art. 4.

¹⁹² *Id.* art. 2.

¹⁹³ This objective is provided as one of the principles for internal controls, *i.e.*, principle of compliance — financial institutions must ensure that its internal control systems comply with applicable laws and regulations. *Id.* art. 7.

but rather it is continually operating at all levels within the bank.¹⁹⁵ Both the PBOC and the Basle Committee emphasize that internal controls are on-going process and each individual within an organization must participate in the process.

The Basle Committee categorizes the main objectives of the internal control process into performance objectives (the internal control process seeks to ensure that personnel throughout the organization are working to achieve its goals with efficiency and integrity, without unintended or excessive cost or placing other interests before those of banks), information objectives (the internal control process seeks to ensure that reports needed for decision-making within the banking organization are prepared timely and reliably), and compliance objectives (the internal control process seeks to ensure that all banking business complies with applicable laws and regulations, supervisory requirements, and the organization's policies and procedures).¹⁹⁶

The Basle Committee compliance objectives are exactly the same as the first objective set in the PBOC Guidelines. The performance objectives set by the Basle Committee are actually set by the PBOC as the third objective — to ensure the full accomplishment of development policies and strategies of the institution. The third category of objectives set by the Basle Committee — reliability, completeness and timeliness of financial and management information (information objectives) are not set by the PBOC Guidelines as objectives for internal controls. The PBOC Guidelines, however, do require the reliability, completeness and timeliness of financial and management information.¹⁹⁷

(ii) Primary Elements of Internal Controls

a. Management Oversight and the Control Culture

Management Oversight The effectiveness of management oversight depends on the organizational structure of a bank. In China, the form and organizational structure of a commercial bank apply the Company Law of the PRC.¹⁹⁸ The Company Law¹⁹⁹ provides two

¹⁹⁴ *Id.* art. 6.

¹⁹⁵ The Basle Framework for Internal Controls, *supra* note 156, at 8.

¹⁹⁶ *Id.*, at 8-9.

¹⁹⁷ The PBOC Guidelines for Enhancing Financial Institution Internal Controls, *supra* note 106, art. 19.

¹⁹⁸ The Commercial Banking Law, *supra* note 18, art. 17.

forms of companies bearing different organizational structures: limited liability companies²⁰⁰ and joint stock companies.²⁰¹ Accordingly, a company should have a shareholders' meeting²⁰² (shareholders' general meeting for a joint stock company²⁰³) as the organ of the authority of the company, a board of directors as the executive organ of the company,²⁰⁴ and the management (manager, deputy managers) in charge of the day-to-day management of the company.²⁰⁵ A joint stock company or a limited liability company with comparatively large size is required to have a supervisory board of not less than three members²⁰⁶ to examine the company's financial affairs, and to supervise the directors and the manager to see whether they violate laws, regulations or the company's articles of association during their performance of company duties; and when an act of a director or the manager is harmful to the company's interests, to require him to correct such act.²⁰⁷ A limited liability company with comparatively small size may have one to two supervisors.²⁰⁸ The Company Law contains provisions on the duties and responsibilities of the company organs and their decision-making procedures.²⁰⁹

The organizational structure provided by the Company Law is consistent with the requirements of the PBOC Guidelines that the organizational structure of a financial institution should be established to keep a balance among the decision-making system, the

¹⁹⁹ The Company Law of the People's Republic of China, adopted at the 5th Session of the Standing Committee of the 8th NPC on December 29, 1993 and effective as of July 1, 1994, as revised at the 13th Session of the 9th NPC Standing Committee on December 25, 1999 (hereinafter referred to as "the Company Law").

²⁰⁰ A limited liability company is a company whose shareholders are liable toward the company to the extent of their respective capital contributions, and the company is liable for its debts to the extent of all its assets. *Id.* art. 3, paragraph 2.

²⁰¹ In a joint stock company, or a company limited by shares, all of the company's capital is divided into equal shares, shareholders are liable toward the company to the extent of their respective shareholdings, and the company is liable for its debts to the extent of all its assets. *Id.* art. 3, paragraph 3.

²⁰² *Id.* art. 37.

²⁰³ *Id.* arts. 102 & 103.

²⁰⁴ *Id.* arts. 45-46 (limited liability company); art. 112 (joint stock company). The board of directors should decide on the business plans and investment plans of the company, formulate the proposed annual financial budgets and final accounts, profit distribution plans and plans for making up losses of the company, plans for the increase or reduction of the registered capital of the company, and should decide on the establishment of the company's internal management organization. *Id.*, arts. 46, 112.

²⁰⁵ *Id.* art. 50 (limited liability company); art. 119 (joint stock company). The manager of a company should carry out the directions of the board of directors, draft plan for establishing the company's internal management organization and the company's basic management system, and should formulate the specific rules and regulations of the company. *Id.* art. 50 & 119.

²⁰⁶ *Id.* art. 124 (joint stock company); art. 54 (limited liability company).

²⁰⁷ *Id.* arts. 126 & 54. The supervisory board of a joint stock company can also propose the holding of extraordinary shareholders' general meetings; and exercise other functions and powers provided for in the company's articles of association. *Id.*

²⁰⁸ *Id.* art. 52.

executive system, and the supervisory system.²¹⁰ It also satisfies the requirements on management oversight of the Basle Committee Internal Control Paper.²¹¹

Control Culture is emphasized in the Basle Committee Internal Control Paper. A strong control culture requires that all personnel at a banking organization understand their role in the internal control process and be fully engaged in the process. The board of directors and senior management therefore should be responsible for promoting high ethical and integrity standards, and for establishing a culture within the organization that emphasizes and demonstrates to all levels of personnel the importance of internal controls.²¹²

The importance of a strong control culture has also been recognized in China.²¹³ The PBOC Guidelines require that a financial institution should carry out training and examination of its staff to ensure that all personnel at the institution understand their role in the internal control process.²¹⁴

b. Risk Recognition and Assessment

The Basle Committee emphasizes the importance of internal risk-management system in its Internal Control Paper. Principle 4 of the Internal Control Paper requires that the material risks that could adversely affect the achievement of the bank's goals are being recognized and continuously assessed. This assessment should cover all risks facing the bank and the consolidated banking organization. And, if necessary, internal controls should be revised to appropriately address any new or previously uncontrolled risks.²¹⁵

The PBOC Guidelines underscore the risk-management-system as well. Risk-controls are set as one of the objectives for internal controls.²¹⁶ Financial institutions are required to follow the principle of prudence and timeliness, adjusting internal controls to address new or previously uncontrolled risks in a timely manner.²¹⁷ Banks are required to assess all risks involved in their operations (local currency/ foreign currency operations, on-balance-sheet/

²⁰⁹ *Id.* arts. 38-44, 46, 49, 50, and 102-119.

²¹⁰ The PBOC Guidelines for Enhancing Financial Institution Internal Controls, *supra* note 106, art. 9.

²¹¹ The Basle Framework for Internal Controls, *supra* note 156, principles 1 & 2.

²¹² *Id.* principle 3.

²¹³ *See, e.g.,* Kang, Shusheng, *supra* note 183, at 60-1.

²¹⁴ The PBOC Guidelines for Enhancing Financial Institution Internal Controls, *supra* note 106, art. 27.

²¹⁵ The Basle Framework for Internal Controls, *supra* note 156, principle 4.

²¹⁶ The PBOC Guidelines for Enhancing Financial Institution Internal Controls, *supra* note 106, art. 6.

²¹⁷ *Id.* art. 7.

off-balance-sheet operations) on a consolidated basis,²¹⁸ especially risks arising out of their lending business.²¹⁹

To control credit risks efficiently, commercial banks are required to issue loans in compliance with laws, administrative regulations, and the PBOC rules. Banks must follow the principles of safety, liquidity, and profitability in their lending businesses. Credit risk management systems should be established to recognize and assess credit risks during the whole life of a loan.²²⁰ An early warning system should be established by monitoring borrowers' creditworthiness constantly.²²¹

c. Control Activities and Segregation of Duties

Control Activities should be an integral part of the daily activities of a bank. According to the Basle Committee Internal Control Paper, an effective internal control system requires that an appropriate control structure be set up, with control activities defined at every business level. These should include: top level reviews; appropriate activity controls for different departments or divisions; physical control; checking for compliance with exposure limits and follow-up on non-compliance; a system of approval and authorization; and, a system of verification and reconciliation.²²²

Similar requirements can be found in China's Commercial Banking Law and the PBOC Guidelines. Accordingly, a financial institution should set up an appropriate control structure, and should establish and improve various systems of approval and authorization according to its operations.²²³

The Commercial Banking Law introduced the concept of "unitary legal entity" and "unitary administration" by providing that a commercial bank should apply to its branches a financial system of unified accounting and centralized fund allocation and level-by-level management. Accordingly, branches of a commercial bank should not be qualified as body

²¹⁸ *Id.* art. 10.

²¹⁹ *Id.* art. 11.

²²⁰ For detailed of credit risk management systems, see Circular on Issues Concerning Loan Management [guanyu jinyibu jiaqiang daikuan guanli youguan wenti de tongzhi], issued by the PBOC January 12, 1998.

²²¹ The PBOC Guidelines for Enhancing Financial Institution Internal Controls, *supra* note 106, art. 11.

²²² The Basle Framework for Internal Controls, *supra* note 156, principle 5.

²²³ The PBOC Guidelines for Enhancing Financial Institution Internal Controls, *supra* note 106, art. 14.

corporate and should do business within the scope authorized by the bank headquarters.²²⁴ Following this theme, the PBOC issued Interim Management Measures of the Scope of Authority of Commercial Bank Functional Departments and Branches in 1996,²²⁵ requiring the headquarters of each commercial bank (including urban and rural cooperative bank) to clarify the powers and authorities of its functional departments and branches, with ceilings set respectively on a branch's lending, discounting, acceptance, and guarantee operations. On January 20, 1999, the PBOC issued Interim Guidelines for Commercial Banks Setting Uniform Exposure Limits,²²⁶ requiring commercial banks to set a consolidated exposure limit for each client as a body corporate, and to review periodically consolidated exposures of the headquarters and branches to a single client to ensure that the consolidated exposure limit is complied with.²²⁷

The PBOC Guidelines provide that authorizations from the headquarters of a commercial bank to its branches or functional departments or divisions should be in written form and should be reviewed periodically.²²⁸ Each branch, department or division should perform its duties according to its authorization.²²⁹ Special approval and authorization is required for transactions beyond the authorization.²³⁰

Segregation of duties, or the "four eyes" principle is established by the Basle Committee Internal Control Paper, which requires that there is appropriate segregation of duties and that personnel are not assigned conflicting responsibilities. Areas of potential conflicts of interest should be identified, minimized, and subject to careful and independent monitoring.²³¹

The Commercial Banking Law and the PBOC Guidelines require segregation of duties as well. With regards to lending operations, the Commercial Banking Law requires that commercial banks implement the system in which the examination and the actual

²²⁴ The Commercial Banking Law, *supra* note 18, art. 22.

²²⁵ Interim Management Measures of the Scope of Authority of Commercial Bank Functional Departments and Branches [shangye yinhang shouquan, shouxin guanli zhanxing banfa], issued by the PBOC on November 11, 1996.

²²⁶ Interim Guidelines for Commercial Banks Setting Uniform Exposure Limits [shangye yinhang shishi tongyi shouxin zhidu zhiying (shixing)], issued by the PBOC on January 20, 1999 and effective as of the same day.

²²⁷ For a comments on the uniform exposure limits system, see, e.g., Yuan, Guanhua, 'Uniform Credit Authorizing System: the Check of Credit Risk [tongyi shouxin zhidu: xindaifengxian de kongzhiqi]', *China Finance* No. 9, 28 (1999).

²²⁸ The PBOC Guidelines for Enhancing Financial Institution Internal Controls, *supra* note 106, art. 14.

²²⁹ *Id.*

²³⁰ *Id.*

extending of a loan are conducted by separate departments and the examination and approval of a loan are conducted at different levels.²³²

The PBOC Guidelines require segregation of duties between (1) the custodian and the book-keeping of cash and securities; (2) the custodian and the use of important blank certificates; (3) the approval and the actual disbursement of funds; (4) the approval and the issuance of credits; and (5) loss verification and writing-off; *etc.*²³³ Cross-checking, double controls of assets and double signatures are also required by the PBOC Guidelines.²³⁴ The Guidelines also provide for periodic reviews of the performance of key personnel of an institution.²³⁵

d. Information and Communication

Adequate information and effective communication are essential to the proper functioning of internal control systems. Under the Basle Committee Internal Control Paper, banks should develop internal control systems that cover internal and external information variables relevant to the management's sound decision-making, *e.g.*, financial, operational, and compliance data. Banks should also develop internal controls with reporting lines that promote the flow of information throughout the bank and that cover information systems and technologies such as in-house back-up and recovery procedures, software development and acquisition policies, and physical/logical access security controls.²³⁶

Information and communication is the weakest link of bank internal controls in China, despite the general requirements respecting the information and communication in banks. The PBOC Guidelines require that financial institutions should establish comprehensive information systems to keep record of every business activity, and to safeguard all original materials and documents.²³⁷ There are also requirements on accounting procedures and electronic information systems.

²³¹ The Basle Framework for Internal Controls, *supra* note 156, principle 6.

²³² The Commercial Banking Law, *supra* note 18, art. 35. *See also* General Lending Rules, *supra* note 99, art. 28.

²³³ The PBOC Guidelines for Enhancing Financial Institution Internal Controls, *supra* note 106, art. 17.

²³⁴ *Id.* arts. 16, 18.

²³⁵ *Id.* art. 18.

²³⁶ The Basle Framework for Internal Controls, *supra* note 156, principles 7, 8 & 9.

²³⁷ The PBOC Guidelines for Enhancing Financial Institution Internal Controls, *supra* note 106, art. 19.

Accounting Procedures The Commercial Banking Law requires that commercial banks establish and improve their financial accounting systems in accordance with the law, unified accounting standards, and relevant stipulations of the PBOC.²³⁸ The PBOC Guidelines require that financial institutions establish strict accounting procedures, including systems of bookkeeping, data processing, and financial analyzing.²³⁹ Evidence for accounting must be verified.²⁴⁰ Business activities should be recorded in a timely manner.²⁴¹

The PBOC Guidelines also establishes principles for accounting procedures — (1) Accounting procedures should in compliance with the generally accepted accounting standards. (2) Accounting staff should carry out their duties within their authorization. (3) Accounting duties should be segregated appropriately. (4) Principle of crosschecking and dual controls. (5) Principle of safety and prudence.²⁴²

On July 30, 1997, the PBOC issued Provisions on Enhancing Internal Accounting Controls and Management in Banks,²⁴³ specifying rules for bank internal accounting control systems.

These requirements for accounting procedures ensure that there are adequate and comprehensive internal financial data. That is essential to the proper functioning of internal controls.²⁴⁴

Electronic Information System Risk Controls Electronic information systems and the use of information technology bear risks that must be effectively controlled by banks to avoid disruptions to business. It is important that these systems be secured, monitored independently, and supported by adequate contingency arrangements.

Computer security has always been a focus of the PBOC. The PBOC Guidelines contain provisions on issues relating to computer security.²⁴⁵ “Decisions on Certain Issues Related to Reinforcing Computer Security and Preventing Financial Computer Crimes” were

²³⁸ The Commercial Banking Law, *supra* note 18, art. 54.

²³⁹ The PBOC Guidelines for Enhancing Financial Institution Internal Controls, *supra* note 106, art. 12.

²⁴⁰ *Id.*

²⁴¹ *Id.*

²⁴² *Id.*

²⁴³ Provisions on Enhancing Internal Accounting Controls and Management in Banks [jing yi bu jiaqiang yinhang kuiji neibu kongzhi he guanli de ruogan guiding], issued by the PBOC on July 30, 1997.

²⁴⁴ The Basle Framework for Internal Controls, *supra* note 156, principle 7.

²⁴⁵ The PBOC Guidelines for Enhancing Financial Institution Internal Controls, *supra* note 106, art. 15.

issued in later 1999. On January 17, 2000, the PBOC held a national computer security meeting to discuss the implementation of the Decisions.²⁴⁶

Problems with the Information and Communication System of Chinese Banks There are problems with the bank information and communication system in China, however. First, the accounting procedures under the PBOC Guidelines pay attention only to internal financial and operational data. Because of the poor disclosure and accounting practices in China, financial institutions have difficulties in collecting information about their clients.²⁴⁷ Second, with regards to electronic information systems, the PBOC Guidelines have only provided for one aspect of the issue, *i.e.*, controlling risks of electronic information systems. The author would like to suggest that financial institutions be encouraged to develop electronic risk recognition and assessing system so as to improve their risk-management capacity.²⁴⁸ Third, the PBOC Guidelines contain no provision on the communication of information. In practice, most financial institutions in China lack effective channels of communication to ensure an adequate flow of information through the organization.²⁴⁹

e. Monitoring Activities and Correcting Deficiencies

According to principles 10, 11 and 12 of the Basle Committee Internal Control Paper, a bank should develop internal controls that can be monitored daily by personnel from several different areas, covering all the bank's activities, branches, and subsidiaries, such that changes in particular areas can be easily integrated into the internal control process to ensure

²⁴⁶ See Chinaonline, 'People's Bank of China Strengthens Computer Security' (January 17, 2000), available at '<http://www.chinaonline.com/topstories/000118/C000118/C00011708.asp>'.

²⁴⁷ Cf. The Basle Framework for Internal Controls, *supra* note 156, principle 7, which reads as follows:

An effective internal control system requires that there are adequate and comprehensive internal financial, operational and compliance data, as well as external market information about events and conditions that are relevant to decision making. Information should be reliable, timely, accessible, and provided in a consistent format.

²⁴⁸ Financial institutions in China started paying attention to electronic risk-management systems. The BOC, for example, signed an agreement with Reuters on June 6, 2000 to use the Kondor + Risk Management system for the bank's financial services operations. This is the first time the BOC has replaced a self-developed system with the technological solutions of a third party. The Reuters Kondor+ System is an applicable system for compounded trading management and risk management. It is equipped with functions for e-commerce, cash management, combined investment analysis, market strategy and credit and risk management. See Chinaonline, 'BOC to Use Reuters' Risk Management System' (June 9, 2000), available at '<http://www.chinaonline.com/industry/financial/currentnews/secure/C00060701.asp>'.

²⁴⁹ Without effective communication, information is useless. That is why the Basle Internal Control Paper requires effective channels of communication to ensure that all staff fully understand and adhere to policies and procedures affecting their duties and responsibilities and that other relevant information is reaching appropriate personnel. The Basle Framework for Internal Controls, *supra* note 156, principle 9.

its effectiveness. Banks should also facilitate reporting of internal control deficiencies, with material deficiencies being reported directly to senior management and the board of directors, through policies and procedures.²⁵⁰

The PBOC Guidelines provide for monitoring activities and correcting deficiencies as well. First, financial institutions are required to establish comprehensive internal controls fitting their particularities, including segregation of duties and crosschecking among different branches, departments, and divisions.²⁵¹ Second, the Guidelines provide that a financial institution should monitor the effectiveness of its internal controls periodically and adjusting its internal controls to the changed operations, Government policies, and State laws.²⁵² Third, financial institutions are required to establish effective EWS, which should include, among other matters, the ongoing monitoring of the internal control systems to detect deficiencies in internal controls.²⁵³ Last but not least, the PBOC Guidelines provide for the internal check and examination of financial institutions' internal controls.

Internal audit is an important part of the system for monitoring activities and correcting deficiencies. Internal auditing system plays a variety of roles.²⁵⁴ The PBOC Guidelines authorize the internal auditing department of a financial institution to manage the internal controls of the institution. The power of the internal auditing department include: (1) to suggest internal controls for various business activities; (2) to monitor and assess internal control systems; (3) to carry out evaluation on specific internal control systems; and (4) to punish those departments or personnel violating internal control rules.²⁵⁵ Financial institutions are required to equip their internal auditing departments with sufficient qualified personnel and to formulate rules to ensure the authority and independence²⁵⁶ of their internal

²⁵⁰ Internal auditors should review deficiency reports on a daily basis and recommend corrective actions to the appropriate management level, both for isolated events and any emerging trends.

²⁵¹ The PBOC Guidelines for Enhancing Financial Institution Internal Controls, *supra* note 106, art. 23.

²⁵² *Id.* art. 25.

²⁵³ *Id.* art. 20.

²⁵⁴ For a discussion on the roles played by internal auditors, see Song, Taili & Wang, Yanbing, 'On Roles of Commercial Bank Internal Auditors [qiantan shangye yinhang neibu shenji jihe de zhuoyong]', *China Finance* No. 9, 41 (1999).

²⁵⁵ The PBOC Guidelines for Enhancing Financial Institution Internal Controls, *supra* note 106, art. 28.

²⁵⁶ The independence of internal auditing department is provided by the PBOC Guidelines as a principle for the establishment of internal controls. *Id.* art. 7.

auditing departments.²⁵⁷ The internal auditing departments should report deficiencies detected and make deficiency correction recommendation in a timely manner.²⁵⁸

(iii) *Evaluation of Internal Control Systems by Supervisory Authorities*

It is recommended by the Basle Committee that banking supervisors assess the internal control system in place at individual banks as part of their ongoing supervisory activities. The supervisors should also determine whether individual bank management gives prompt attention to any problems that are detected through the internal control process.²⁵⁹

The PBOC Guidelines also vest the PBOC with the power to evaluate internal control systems in financial institutions. Accordingly, the PBOC should assess the internal control system in place as part of their ongoing supervisory activities. And, if necessary, the PBOC may trust accounting firms to conduct external auditing to assess the internal controls of a financial institution. The PBOC may suggest deficiency correction to those financial institutions whose internal controls are problematic or impose legal liabilities on institutions or responsible personnel.²⁶⁰

C. PROBLEMS WITH INTERNAL CONTROLS IN CHINA'S COMMERCIAL BANKS

As shown above, the PBOC Guidelines are in line with the Basle Committee Internal Control Paper. The real problem is how well these rules can be implemented in China. Two examples support this assertion, the organizational structure of State commercial banks and the information problem. The State commercial banks, because of their sole state ownership, do not have the shareholders' meeting as a check and balance power, resulting in their weak corporate governance. The information is always the weakest part of bank internal controls in China. Efforts have been made by the PBOC recently to help commercial banks collect information about the creditworthiness of their borrowers. It takes time, however, for banks to develop skills and expertise to analyze the information.

²⁵⁷ *Id.* art. 22.

²⁵⁸ *Id.* art. 16.

²⁵⁹ The Basle Core Principles, *supra* note 71, principle 14; and the Basle Framework for Internal Controls, *supra* note 156, principle 13.

²⁶⁰ The PBOC Guidelines for Enhancing Financial Institution Internal Controls, *supra* note 106, art. 29.

1. The Organizational Structure of State Commercial Banks

(i) *The Organizational Structure of State Commercial Banks*

The organizational structure of State commercial banks is unique because the “big four” are solely State-owned. Their organizational structure applies that of the wholly State-owned companies.²⁶¹ According to the Company Law, a wholly State-owned company does not have a shareholders’ meeting. The organization authorized by the State to make investments or the department authorized by the State should authorize the company’s board of directors to exercise part of the functions and powers of a shareholders’ meeting and to decide the major matters of the company except the merger, division, dissolution, increase or decrease of capital, and the issue of company bonds of and by the company.²⁶² A wholly State-owned company does have a board of directors, which exercises functions and powers in accordance with article 46 (functions and powers of the board of directors of a limited liability company), and article 66 of the Company Law.²⁶³ A wholly State-owned company has a manager as well, who should be engaged or dismissed by the board of directors. The manager exercises functions and powers in accordance with article 50 (functions and powers of the manager of a limited liability company) of the Company Law.²⁶⁴ A wholly State-owned company will have a board of supervisors. Its members are mainly designated by the State Council or related departments or organizations authorized by the State Council, and should also include employee representatives²⁶⁵ (see Annex XIV, which reviews the development of board of supervisors for State commercial banks).

To sum up, under its current organizational structure, there are only a board of directors, management, and a board of supervisors within a State commercial bank, with the functions of the shareholders’ meeting partly played by the board of directors and partly by

²⁶¹ A wholly State-owned company means a limited liability company invested in and established solely by an organization authorized by the State to make investments or department authorized by the State. The Company Law, *supra* note 199, art. 64.

²⁶² *Id.* art. 66. Decisions related to the merger, division, dissolution, increase or decrease of capital, and the issue of company bonds should be made by the organization authorized by the State to make investments or the department authorized by the State. *Id.*

²⁶³ *Id.* art. 68.

²⁶⁴ *Id.* art. 69.

²⁶⁵ *Id.* art. 67.

government departments. This structure lacks effective check and balance, because the board of directors is authorized to carry out the functions and powers that should be carried out by the shareholders' meeting,²⁶⁶ and because a member of the board of directors may serve concurrently as the manager.²⁶⁷ The board of supervisors might be a checking power, but their check cannot be as effective as that of the shareholders' meeting.²⁶⁸ This organizational structure will have to be improved.

(ii) *Diversifying the Ownership Structure of the "Big Four": a Solution to Their Corporate Governance Problem?*

There have been strong arguments for diversifying the banks' ownership based on the NPL prevention and the preparation for the competition after China's WTO membership. A report released by the Chinese Academy of Social Sciences immediately after the US/China WTO deal, for example, asserted that the government must allow non-state investors, including foreigners, to buy into its "big four" banks "to eradicate the structural elements causing bad assets."²⁶⁹

The current author would like to argue for the diversification of ownership structure of the "big four" in terms of corporate governance. The weak corporate governance has always been blamed for the poor performance of China's commercial banks.²⁷⁰ It has been a consensus that the State ownership blocked the process of bank commercialization²⁷¹ — the State-ownership has facilitated government intervention into banks²⁷² and led to banks' lack

²⁶⁶ *Id.* art. 66.

²⁶⁷ *Id.* art. 69.

²⁶⁸ The supervisors can only attend the board of directors meetings as non-voting delegates. Moreover, not like the board of supervisors of a limited liability company, the board of supervisors of a solely State-owned company does not have the power to require correcting actions if an act of a director or the manager is harmful to the company's interest. *Id.* art. 67.

²⁶⁹ See Reuters English News Service, 'China: China's WTO Deal Heralds Radical Banking Reform' (November 16, 1999).

²⁷⁰ See *Strengthening the Banking System in China: Issues and Experience*, BIS Policy Papers No. 7, 331 (October 1999).

²⁷¹ See, e.g., Kynge, James, 'Beijing: China Bank Reform "Yet to Tackle All Faults"', *Fin. Times* (August 18, 1999).

²⁷² See Zhao, Haikuan, 'The State Commercial Banks Should Be Converted into Joint Stock Banks [guoyou shangye yinhang yiyu shixing gufengzhi]', *China Finance (Beijing)* No. 11, 26, at 26 (November 1999).

of incentives to improve their operation.²⁷³ Moreover, as mentioned before, the State ownership also leads to an unbalanced corporate government structure in State commercial banks.

There are two obstacles to the diversification of the ownership structure of State-owned banks, however. The first one is a legal obstacle. Ownership control on banks and non-bank financial institutions has been employed by the PBOC as a tool to protect State banks from competition. According to the provisional regulations issued in 1994,²⁷⁴ foreign-funded and Sino-foreign joint equity financial institutions or enterprises are not allowed to invest in Chinese-funded financial institutions;²⁷⁵ and, unless approved by the PBOC headquarters, a financial institution (apart from urban credit cooperatives and rural credit cooperatives) is not permitted to raise share capital from the public.²⁷⁶ By the end of 1999, Shenzhen Development Bank and Shanghai Pudong Development Bank were China's only listed commercial banks.²⁷⁷ China Minsheng Bank went public in December 2000.²⁷⁸ Despite the signs that the restrictions are being relaxed recently,²⁷⁹ there is no indication from the authorities that the government has any plan to sell their stakes in the "big four". Xie, Ping, the Director of the PBOC Research Bureau, for example, argues that "[w]hile it is generally acknowledged that privatization goes hand-in-hand with improved efficiency, this might not be the case in China because the very fact that the banks are owned by the State reassures the depositors."²⁸⁰

²⁷³ The State-ownership means the banks have an implicit guarantee from the government. Besides, because the banks are operating under the government's instruction, so far as it can carry out tasks imposed by the government, the banks will not be punished for their low profitability. *Id.*

²⁷⁴ Provisional Regulations Concerning Investment in Financial Institutions through Purchase of Shares, promulgated by the PBOC on 28th July 1994.

²⁷⁵ *Id.*, Sect. 12.

²⁷⁶ *Id.*, Sect. 14.

²⁷⁷ See Chinaonline, 'Bank of Communications Prepare to Go Public' (July 7, 2000), available at '<http://www.chinaonline.com/topstories/000707/1/C00070505.asp>'.

²⁷⁸ See Kynge, James, 'China's Public Show of Capitalism', *Fin. Times* (December 17, 2000).

²⁷⁹ It was reported that the PBOC is throwing its support behind a new joint stock plan for the country's commercial banks. See, e.g., Chinaonline, 'China's Central Bank Backs Joint Stock Plan for Commercial Banks' (November 11, 1999), available at '<http://www.chinaonline.com/industry/fina...rchive/Secure/1999/November/C9111004.asp>'.

²⁸⁰ *Supra* note 270, at 329. Xie admitted, though, that it should be realized that joint-ownership helps commercial banks to strengthen their capital bases and to improved governance. *Id.*

It was reported that the PBOC would allow the "big four" to issue long-term financial bonds to absorb private funds and supplement capital. That might be the furthest the PBOC would go at this moment. See Chinaonline, 'State-owned Commercial Banks to Offer Long-term Financial Bonds' (March 14, 2001), available at '<http://www.chinaonline.com/topstories/010314/1/C01031302.asp>'.

Second, even if the government intended to sell their stakes in the “big four”, there would be difficulties in diversifying the ownership structure of the “big four”. Wang, Songqi, Deputy Director of the Finance Research Center of the Chinese Academy of Social Sciences, discussed three ways of diversifying the ownership structure of State commercial banks — listing in stock exchanges, selling equity to domestic non-state entities, or transferring equity to foreign investors — and concluded that it was unrealistic to diversify the ownership of State commercial banks by selling State stakes to domestic investors.²⁸¹ The only possibility, Wang argued, was to sell off partial equity of the “big four” to foreign investors.²⁸² Without an obvious improvement in the asset quality of the “big four”, it is doubtful whether foreign investors will be interested in purchasing stakes in them.²⁸³

2. The Information Problem

As mentioned before, information and communication is the weakest part of bank internal controls in China. Because of the poor disclosure and accounting practices, financial institutions have difficulties in collecting information about their clients. Efforts have been made by the PBOC these years to help commercial banks obtain information about their borrowers (see Annex XV). Commercial banks in China, however, will have to develop skills and techniques to analyze the information themselves and it takes time for banks to develop these skills and techniques.

3. Prospects

China is in the right direction to improve bank internal controls. The problem now is not the lack of rules, but how can these rules be carried out fully in China. It seems to the author that it is easier to identify a problem than to really solve the problem. Taking the weakness of the governance structure of State commercial banks, and the information problem for example, it

²⁸¹ See Chinaonline, ‘WTO Entry to Hurt China’s State-owned Commercial Banks’ (November 29, 1999), available at <http://www.chinaonline.com/industry/financial/currentnews/open/B9112403-SS.asp>.

²⁸² *Id.*

²⁸³ This has already been realized by Chinese policy-makers. Dai, Xianglong, the PBOC governor set out a road map for reforms to the “big four” at a PBOC press conference on January 19, 2000. He said that the State banks had to slash their payrolls, clear out bad loans and exercise strict “credit discipline” before they could be

is clear that these two problems must be solved. It takes time to solve these problems, however.

V. SUMMARY

Enhancing prudential banking regulation/supervision and promoting bank internal controls are essential to prevent the creation of new NPLs on China State commercial banks' balance sheets.

China has developed its prudential banking regulation and supervision in line with the Basle Committee Core Principles for Effective Banking Supervision. There are problems with banking regulation and supervision in China, however. First, because of the difficulties faced by SOEs, administrative controls on commercial banks have not been removed completely. The interest rate control, despite its relaxation, remains a main feature of China's financial system. And, despite of the removal of credit ceilings on January 1, 1998, at least in 1999, most of the credits were still directly controlled and regulated. Second, there are problems with banking supervision in China. The licensing and structure change approval procedures are not transparent enough. Among other matters, on-going supervision need to be improved — clearer rules are needed for on-site examinations; attention needs to be paid to how to make good use of external independent auditors; a more efficient EWS needs to be established. Third, the sanction provisions in China are mainly *ex post* punishments rather than incentives for banks to correct their operations. The solution of these problems takes time and cannot be taken for granted.

To enhance internal controls in Chinese financial institutions, the PBOC issued Guidelines for Enhancing Internal Controls of Financial Institutions in 1997. The Guidelines give definition and objectives to internal controls consistent with the Basle Committee Internal Control Paper and cover all primary elements of bank internal controls — namely — management oversight and control culture, risk recognition and assessment, control activities and segregation of duties, information and communication, and monitoring activities and correcting deficiencies. The problem is not that China lacks clear rules for developing bank internal controls, but how well these rules can be carried out by Chinese banks. Taking State

transformed into “shareholding” companies. See Kynge, James, ‘China to Speed up Financial Reforms’, *Fin.*

commercial banks for an example, because the “big four” are solely State owned, there is no shareholders’ meeting in the “big four”, resulting in their poor corporate governance. Besides, information and communication is always the weakest part of bank internal controls in China. The solution of these two problems takes time.

I. INTRODUCTION — DESIGNING A BANKING SAFETY NET

A banking safety net can be defined as a set of mechanisms designed to prevent or reverse widespread de-intermediation from banks, losses in bank capital, and bank failures.¹ In this view, prudential regulation and supervision should be recognized as a component of the banking safety net as well.² The deposit insurance, lender of last resort (LOLR), and prudential regulation and supervision, are considered to constitute the tripartite safety nets in the present model for financial stability.³

The focus of this chapter is the safety net for individual banks.⁴ Accordingly, the author will discuss a tripartite banking safety net comprising a deposit insurance scheme, LOLR, and insolvency resolution. Banking regulation and supervision is not to be discussed in this chapter for two reasons. First, banking prudential regulation and supervision is such a broad term that it is not limited to individual bank crisis management.⁵ Second, banking prudential regulation and supervision has already been discussed in Chapter Three.

The rest of the chapter comprises four sections. In Section II, issues related to the LOLR are surveyed, with suggestions on how to define LOLR facilities in China. Section III

¹ See Demirguc-Kunt, Asli, *Designing a Bank Safety Net — A Long-term Perspective*, World Bank Mimeo (1999), available at 'http://www1.worldbank.org/finance/html/designing_a_bank_sn.html'.

² Some authors include prudential regulation and supervision as part of a banking safety net. See, e.g., Demirguc-Kunt, Asli, *supra* note 1.

³ See, e.g., Ketcha, Nicholas J Jr., 'Deposit Insurance System Design and Considerations' in *Strengthening the Banking System in China: Issues and Experience*, BIS Policy Papers No. 7, 221 (October 1999).

⁴ "Crisis situations" of individual banks include situations of either liquidity or insolvency that may threaten the continuation of the activities of a particular bank or banks on a temporary or permanent basis, often a result of management mistakes of the particular bank(s). These situations are different from a generalized banking crisis (a system crisis), which is often a result or a reflection of the deterioration of the economic environment or of poor macroeconomic management. See, e.g., Lastra, Rosa Maria, *Central Banking and Banking Regulation*, 124-5 (1996). In a systemic banking crisis, the safety net designed for individual bank crisis might not suffice, a systematic solution will therefore be needed. The whole thesis is actually devoted to the systematic solution to the NPL problem trapping China's banking system.

⁵ *Id.* Dr. Lastra divides the bank supervisory process into four stages: licensing, supervision *stricto sensu*, sanctioning and crisis management, which comprises lender of last resort, deposit insurance and special bank insolvency proceedings. *Id.*, at 5.

focuses on designing a deposit insurance program to fit China's need, referring to international experience and lessons. Mechanisms for bank insolvency resolution are discussed in Section IV. The chapter ends with concluding observations in Section V.

II. DEFINING THE LENDER-OF-LAST-RESORT IN CHINA

A. A GENERAL INTRODUCTION

1. Understanding the LOLR Properly

The central bank lending to commercial banks (or other financial institutions) can be made under various situations. A central bank may lend to commercial banks for the implementation of monetary policy. The central bank may also lend as a liquidity source or “bankers’ bank”: Due to the nature of the business and the structure of its balance sheet (non-marketable assets and demand deposit), a bank may need to borrow from the central bank for the need of its normal business. These two kinds of central banking lending are not the LOLR facilities discussed here. The LOLR in this chapter is an instrument of banking supervision in a “crisis situation” stage, *i.e.*, the central bank provides assistance to a bank (or banks) suffering from a liquidity crisis.

The LOLR facilities should be distinguished from central bank lending as monetary policy. It is argued that: “For the sake of economic stability, it is important that the Fed distinguish at all times between its monetary policy and its LOLR function. The lender of last resort should replace liquidity lost as a result of customer demands; it should not force additional liquidity into the system.”⁶

Because a central bank can both act as “banker’s bank” and as “banking supervisor”, the distinction between these two aspects of central bank lending is not very relevant in practice, at least in those countries where central banks function as banking supervisor as well. The distinction, however, is relevant in countries where central banks do not function as banking supervisor, such as in the UK, where a Financial Service Authority was set up to take the banking supervisory responsibilities from the Bank of England. In these countries, it is even not right (at least not exact) to define the LOLR as an instrument of banking

⁶ See Benston, G., *et al.*, *Safety and Sound Banking: Past Present and Future*, 113 (1986).

supervision in “crisis situation” stage. Rather, it will be better to define it as an instrument to carry out central bank’s responsibility for financial stability.

2. The History and Theoretical Foundation of the LOLR

The term lender of last resort was first introduced by Sir Francis Barings, who in 1797 referred to the Bank of England as the “dernier resort” from which all banks could obtain liquidity in times of crises.⁷ The theoretical foundation of the LOLR doctrine was first set by Thornton in 1802 and refined by Bagehot in 1873⁸ — *i.e.*⁹ — (1) The central bank — acting as the LOLR — should prevent temporary illiquid but solvent banks from failing. (This type of lending is by nature short term). (2) The central bank should lend freely, but charge a penalty rate. (3) The central bank should accommodate anyone with good collateral, valued at pre-panic prices. (4) The central bank should make its readiness to lend freely clear in advance.

Two further operating principles typically apply.¹⁰ First, the central bank’s LOLR role is discretionary, not mandatory.¹¹ Second, the central bank assesses not only whether the situation is of liquidity or solvency, but also whether the failure of an institution can trigger by contagion the failure of other institutions.

3. Defining the LOLR in Practice

It is by no means an easy job to define a central bank’s LOLR role in practice, at least not as easy as setting the theoretical principles for the LOLR. The definition and principles set out in the previous section are not always followed in practice.

First, the LOLR’s guiding principle — lending to illiquid but solvent institutions — seldom seems to be applied.¹² This may be because the distinction between whether a bank is illiquid or insolvent is not always clear when the lending decision is made. For example, a

⁷ See, e.g., Lastra, R. M. ‘Crisis Management and Lender of Last Resort’ in Lastra, R. M., Schiffman, Henry N. (eds.), *Bank Failures and Bank Insolvency Law in Economies in Transition*, 21, at 21 (1999).

⁸ See Lastra, Rosa Maria, *supra* note 4, at 126 and n. 220.

⁹ *Id.*, at 127.

¹⁰ *Id.*

¹¹ See, e.g., Federal Reserve Act, 10 (b), as amended by the Federal Deposit Corporation Improvement Act in 1991, which reads as follows:

A Federal Reserve Bank shall have no obligation to make, increase, renew, or extend any advance or discount under this Act to any depository institution.

US study found that 90% of LOLR credit extended by the Fed went to banks that subsequently failed.¹³ During the recent Asian financial crisis, central banks in all crisis countries provided liquidity under various emergency lending and LOLR facilities to banks that were already insolvent.¹⁴

Two reasons can be attributed to the disparity between theory and practice:¹⁵ (1) With developed money and inter-bank markets the central bank is typically called upon to assist an institution when other sources of financing have dried up (*i.e.*, when there is a perception in the market that such institution is already suffering from insolvency problems).¹⁶ (2) The immediacy of the need for such assistance often makes it difficult to assess at that moment whether the institution is illiquid or insolvent. A situation of bank illiquidity (*i.e.*, lack of illiquid funds) can be an indication of technical insolvency (*i.e.*, value of liabilities exceeds market value of assets) or can quickly turn into insolvency if assets are sold at loss value or fire sale price.

Second, as mentioned above, in deciding LOLR, a central bank assesses not only whether the situation is of liquidity or solvency, but also whether the failure of an institution can trigger by contagion the failure of other institutions. In other words, a LOLR is designed to avert banking panics, but not individual bank runs. While it is easy to draw conceptual distinction between banking run and banking panic,¹⁷ it is by no means an easy job to make

¹² See Lastra, R. M., *supra* note 7, at 27.

¹³ Cited in Garcia, G, *Deposit Insurance: A Survey of Actual and Best Practices*, IMF Working Paper 99/54, 23 (April 1999).

¹⁴ *E.g.*, in South Korea, 10.2 trillion won and \$13.3bn liquidity supports were provided respectively in November and December 1997, accounting for 7% of GDP; in Thailand, altogether 1,037bn baht were provided in early 1997, accounting for 22% of GDP. See Balino, Tomas J. T., Enoch Charles *et al.*, *Financial Sector Crisis and Restructuring Lessons from Asia*, 26 & table 3 (IMF, September 1999).

¹⁵ See Lastra, R. M., *supra* note 7, at 27-8.

¹⁶ Dr. Lastra refers to Goodhart and Schoenmaker to support this point. Those two authors argue that “with an efficient money and inter-bank market, a commercial bank that is generally believed to be solvent, can almost always, obtain sufficient additional money to meet its liquidity difficulties” and, therefore the central bank will generally act as LOLR “in circumstances where the solvency of the borrower is subject to doubt.” *Id.*, at 28.

¹⁷ A widespread demand by depositors for immediate conversion of their deposits into currency is termed a bank run. A run that spreads from one bank to other solvent banks because of a loss of confidence in the banking system is termed a banking panic.

Individual bank runs should not threaten the whole banking system, because — (1) A run on an individual bank need not lead to its insolvency. The run can be halted and confidence in the bank restored by a demonstration that an ample supply of currency is available to satisfy all depositor demands (a sound bank shall be able to borrow from the market). (2) Even if that bank is forced into solvent, the failure of that bank does not necessarily result in a multiple contraction of deposits and reduces the stock of money of the financial system. Depositors might move from one institution perceived to be unsound to another perceived to be sound or switch from deposits to safe securities.

Banking panic is different. Because all banks will need liquidity in a banking panic, only if additional currency and reserves are provided to the banking system can the damaging effects on the aggregate money stock of a panic be avoided.

the distinction in practice. When there is an individual bank run, it is hard for a central bank to judge whether it will lead to a banking panic or not. Making matters worse, the central bank takes the risk of triggering banking panic if it refuses to provide liquidity support to individual banks, because the market may misinterpret that the central bank is not ready to lend. That explains why practically, a central bank provide emergency lending to preserve the stability of the banking system as a whole by supplying extra reserves to all banks suffering from large cash withdrawals, as well as to support a single bank suffering from a liquidity crisis.

Third, it is increasingly difficult to define a scope of financial institutions that can access the LOLR. The growing blurring of frontiers between the banking and the securities business have led to an extension of the safety net — “Though the central bank typically bails out domestic commercial banks, it can also stand ready to provide emergency liquidity assistance to securities firms and other financial institutions, as the Fed did in the stock market crash of October 1987.”¹⁸ In the US, Regulation A of the Federal Reserve System allows the Fed to extend emergency credit to “individuals, partnerships and corporations that are not depository institutions if, in the judgment of the Federal Reserve Bank, credit is not available from other sources and failure to obtain such credit would adversely affect the economy.”¹⁹ The Fed can also agree to supply emergency liquidity to foreign institutions operating in the country — Regulation A provides that “except as may be otherwise provided, this part [*i.e.*, the extension of credit by Federal Reserve banks] shall be applicable to United States branches and agencies of foreign banks subject to reserve requirements under Regulation D in the same manner and to the same extent as [domestic] depository institutions.”²⁰

B. DEFINING THE PBOC’S LOLR ROLE

1. The PBOC’s LOLR Role Is Not Well Defined in China

¹⁸ See Lastra, Rosa Maria, *supra* note 4, at 126.

¹⁹ 12 CFR 201.3 (d).

²⁰ 12 CFR 201.7 (CFR revised as of January 1, 1996). However, “the rate applicable to such credit will be above the highest rate in effect for advances to depository institutions. Where the collateral used to secure such credit consists of assets other than obligations of, or fully guaranteed as to principal or interest by, the United States or an agency thereof, an affirmative vote of five or more members of the Board of Governors is required before credit may be extended.”

In China, the conditions and procedure to provide LOLR are not clearly defined. There are provisions in the Central Banking Law that the PBOC can lend to commercial banks for monetary policy purpose.²¹ Besides, the Central Banking Law authorizes the PBOC to “maintain the legitimate, stable and sound operation of the financial industry.”²² Even if these two articles could be understood as the legal basis for the PBOC’s LOLR role, they are by all means only broad provisions, leaving the conditions and procedure to provide liquidity totally at the discretion of the PBOC.

In 1993, the PBOC issued Interim Measures Governing the PBOC Lending to Financial Institutions.²³ Under the Measures, the PBOC can extend credit to financial institutions through either advances or discounts.²⁴ The term of the advance can be 20 days, three months, six months or one year,²⁵ while discounts can be up to 6 months.²⁶ According to the Measures, only those financial institutions established with the approval of the PBOC, holding a financial business permit, and having basic account with the PBOC are eligible to apply for the PBOC credit.²⁷ To be qualified for the PBOC advances or discounts, a financial institution must not occur severe liquid problem, and shows the creditworthiness and capacity to repay the PBOC credit.²⁸ In other words, the Interim Measures have not much to do with the PBOC’s LOLR role.

Because of the lack of rules, in practice, the PBOC follows a case-by-case approach in providing LOLR supports. This kind of practice, while granting the central bank some “constructive ambiguity” about the conditions under which it will provide assistance so as to discourage banks from relying on it,²⁹ leave the PBOC vulnerable to political pressures from the central and local governments.

Due to the lack of information, we cannot tell how well the PBOC has played its LOLR role in China. But at least in one case, liquidity support was given to an insolvent

²¹ The Law of the People’s Republic of China on the People’s Bank of China, adopted at the 3rd Session of the Eighth National People’s Congress on March 18, 1995, effective as of the same date (hereinafter referred to as “the Central Banking Law”), art. 27, which reads as follows:

The People’s Bank of China may, as needed for implementing monetary policies, determine the amounts, duration, rate of interest and form of loans to commercial banks, but the duration shall not exceed one year.

²² *Id.* art. 30.

²³ Interim Measures Governing the PBOC Lending to Financial Institutions [zhongguo renmin yinhang dui jinrong jiguo daikuan guanli zhanxing bangfa], issued by the PBOC on March 3, 1993.

²⁴ *Id.*, art. 8.

²⁵ *Id.*, art. 9.

²⁶ *Id.*, art. 10.

²⁷ *Id.*, art. 6.

²⁸ *Id.*, art. 7.

²⁹ See Hawkins, John & Turner Philip, ‘Bank Restructuring in Practice: An Overview’ in *Bank Restructuring in Practice*, 6, 52, BIS Policy Papers No. 6 (August 1999).

financial institution. In December 1997, just one month before the closure of the Hainan Development Bank, the central bank provided more than RMB3bn in liquidity support to it.³⁰

2. Legal Definition of the LOLR: the US, UK and Japan Models

(i) *The US Model*

In the US, the terms and conditions of liquidity provision to specific banks are statutory defined. Regulation A clearly states the conditions in which the Federal Reserve Banks can extend credit.³¹

Regulation A raises several situations in which credit is to be advanced to depository institutions. The LOLR is what the Regulation refers to as “extended credit”.³² Accordingly, “extended credit” is provided when “similar assistance is not reasonably available from other sources...where there are exceptional circumstances or practices affecting a particular depository institution including deposit drains, impaired access to money market funds, or sudden deterioration in loan repayment performance...the extended credit will be made to depository institutions that may be experiencing difficulties adjusting to changing money market conditions over a long period.”³³

There is also a limitation to who can access the extended credit. First, only those that have been appraised as “critically undercapitalized”³⁴ or “undercapitalized”³⁵ can request the advance. Second, only insured depository institutions are eligible for this credit.

The credit advance is also limited in maturity — “no advances...may be outstanding for more than 60 days in any 120-day period” unless “the head of the appropriate Federal banking agency certifies in advance in writing to the Federal Reserve Bank that any

³⁰ See Xie, Ping, ‘Bank Restructuring in China’ in *Bank Restructuring in Practices*, 124, at 125-6, BIS Policy Papers No.6 (August 1999).

³¹ 12 CFR 201.

³² This is opposed to “adjustment credit” (which is advanced for temporary requirements or to cushion more persistent shortfalls of funds pending an orderly adjustment (12 CFR 201.3 (a))), “seasonal credit” (which is extended for periods longer than adjustment credit to assist small institutions meet expected fluctuations in deposits and loans (12 CFR 201.3 (b))), and “emergency credit” (12 CFR 201.3 (b)).

³³ 12 CFR 201.3 (c).

³⁴ An institution is critically undercapitalized, according to section 38 of the Federal Deposit Insurance Act as amended by FDICIA when it “fails to meet any level specified under subsection c (3)(a)”, (*i.e.*, when the leverage ratio of tangible equity is less than 2% of total assets).

³⁵ An undercapitalized depository institution is defined as not critically undercapitalized, deemed to be undercapitalized under the FDICIA, and has received a CAMEL rating of 5 or equivalent. 12 CFR 201.2(h).

depository institution is viable.”³⁶ Satisfactory collateral is required.³⁷ And a penal interest rate above the market rate will be charged.³⁸

The LOLR is discretionary rather than compulsory. This has been stressed by the FDICIA’s amendment to Section 10 (b) of Federal Reserve Act: “A Federal Reserve bank shall have no obligation to make, increase, renew, or extend any advance or discount under this Act to any depository institution.”

To discourage the Federal Reserve from lending to insolvent institutions in an emergency crisis, the 1991 Federal Deposit Insurance Corporation Improvement Act (FDICIA) provides strictly that Federal Reserve banks may have outstanding advances to critically undercapitalized depository institutions “only during the 5-day period beginning on the date the institution became critically undercapitalized or after consultations with the Board. After the end of this 5-day period, the Board [of Governors] shall be liable to the Federal Deposit Insurance Corporation for the excess loss (*i.e.*, for the loss that exceeds the loss that the FDIC would have incurred if it had liquidated the institution as of the end of that 5-day period), without regard to the terms of advance or any collateral pledged to secure the advance.”³⁹

(ii) *The UK Model*

The UK approach of defining the LOLR is contrary to the US. There is no clear statutory definition of the circumstances for their LOLR facilities. Actually, the Bank of England (BOE) is not even statutorily required to provide emergency credit or to oversee the stability of the financial system. The role of ensuring financial stability has been developed by practices of the BOE at first,⁴⁰ and was later laid out in the Chancellor’s statement on May 20, 1997.⁴¹

³⁶ Federal Reserve Act sections 10 (a) and 10 (b), as amended by FDICIA on December 19, 1991.

³⁷ 12 CFR 201.5.

³⁸ 12 CFR 201.52.

³⁹ Federal Reserve Act section 10 (b), as amended by FDICIA on December 19, 1991. Cited in Lastra, R. M., *supra* note 7, at 29.

⁴⁰ The BOE, for example, supplied liquidity in the Overend and Gurney Crisis (1866) and the City of Glasgow Bank failure (1878). In the first Baring Crisis (1890), the BOE stood ready to do so. *See, e.g.*, Wood, Geoffrey E., ‘Crisis Management and Lender of Last Resort and Deposit Insurance in Economies in Transition: Comment — Routes to Systemic Stability’ in Lastra, R. M., Schiffman, Henry N. (eds.), *Bank Failures and Bank Insolvency Law in Economies in Transition*, 71, at 72 (1999).

⁴¹ *See* Rodgers P., ‘Changes at the Bank of England’, *Bank of England Q. Bull.*, 246 (August 1997). In October 1997, the BOE, Treasury and the Financial Service Authority exchanged a Memorandum of Understanding (MOU), clarifying the framework for cooperation on financial stability.

According to the letter exchanged between the BOE, the Treasury, and the Financial Service Authority (FSA) on October 1997, LOLR facilities will only be provided in “exceptional circumstances”; and there must be “a genuine threat to the stability of the financial system to avoid a serious disturbance in the UK economy.”⁴²

The attitude of the BOE toward the LOLR provision has changed over the past decades. The BOE previously encouraged troubled institutions to take remedial actions by seeking refinancing from shareholders of the institution. Later on, the BOE became more pre-committed to act as a LOLR — although the BOE still limited its financial exposure to minimal levels and only extended emergency credit when other parties were not willing to assist, it was reluctant to leave a troubled bank unattended, whether it was illiquid or insolvent.⁴³

Following the enactment of the Bank of England Act in 1998, it is predicted that the BOE will become more cautious in providing emergency credit since it will have to consult with two other parties (the Treasury and the FSA). Besides, the accountability required by the Bank of England Act will necessitate clear reasoning and criteria when any such operation is carried out.⁴⁴

(iii) *The Japan Model*

In Japan, the LOLR is stated in the Bank of Japan Law. Under the law, the Bank of Japan can provide credit to maintain an orderly financial system⁴⁵ and when a situation stated in the Banking Act arises (*i.e.*, when there is a serious threat to the safety and soundness of the financial system, and cease of operations or revocation of banking license is contemplated).⁴⁶ The Bank of Japan is restricted in extending liquidity support because their LOLR facilities can only be triggered by a request from the Ministry of Finance.⁴⁷ And, only on exceptional situations can loans be made without collateral.⁴⁸

⁴² See Rodgers P., ‘The Bank of England Act’, *Bank of England Q. Bull.*, 97-99 (May 1998).

⁴³ See Hadjiemmanuil, Christos, *Banking Regulation and the Bank of England*, 267 (1996).

⁴⁴ Bank of England Act 1998, sect. 15, which requires any decision involving intervention in the financial market should be publicized.

⁴⁵ Bank of Japan Law, art. 38-1.

⁴⁶ Art. 57-2 of Japan Banking Law (Law No. 59 of 1981) states that the Financial Revitalization Commission should consult the Ministry of Finance when there is a serious threat to the safety and soundness of the financial system, and cease of operations or revocation of banking license is contemplated.

⁴⁷ Bank of Japan Law, art. 38.

⁴⁸ *Id.*, art. 38 and art. 37-1, which provides that loans can be made un-collateralized for an exceptional and accidental situation of computer failures.

3. Implications for China

It is hard to compare between these three models introduced just above. There are things common among them, however. In all the three countries, the central bank is pre-committed to extend credit to illiquid financial institutions at a penalty rate on collateral. Moreover, as a reflection of the global trend of concerns over moral hazard, pre-conditions are set for central bank's LOLR facilities. In the UK and Japan, a support operation can only be provided when there is genuine, serious threat to the soundness and stability of the financial system. In the US, more detailed rules are set. The maturity of LOLR facilities is also subject to ceiling in these three countries. Moreover, there are procedural requirements for the central bank to extend credit as the LOLR. In Japan, a MOF request is required. In the UK, the BOE must consult with the Treasury and the FSA. While in the US, the authority of the Board of Governor of the Federal Reserve System and its decision-making procedure are clearly provided by legislation. Given the difficulties in distinguishing between illiquid and insolvent banks,⁴⁹ these procedural provisions are essential to check that a central bank plays its LOLR role properly.

Given the legal tradition in China,⁵⁰ the author would not recommend the UK model for China. The application of the US model requires that the country has highly-qualified banking supervisors and advanced supervisory instruments, which are yet to be developed in China, at least at this stage.

The Japan model, *i.e.*, defining the LOLR role of the central bank by provisions in central banking law, with financial stability as the primary objective, might be the best option for China. It must be clarified that the central bank should only extend credit to those temporary illiquid but not insolvent financial institutions when there is threat to the soundness and stability of the financial system and the extension of the credit is necessary to avoid a serious disturbance in the economy. The credit advance should be limited in maturity and extendibility and require satisfactory collateral. More importantly, procedures for decision-making should be described by the legislation as well, including the authority of the person or persons to make the decision (the PBOC Governor, or the PBOC Monetary Policy

⁴⁹ This is even true in countries like the US. It was revealed that 90% of lender of last resort credit extended by the Federal Reserve went to banks that subsequently failed. See, *e.g.*, Garcia, G, *supra* note 13, at 23

⁵⁰ China has the tradition of writing law.

Commission) and the consultative requirements (such as the requirement that the PBOC should consult with the MOF before it decides to extend emergency credit).

III. INTRODUCING A DEPOSIT INSURANCE SYSTEM INTO CHINA

A. WHY DEPOSIT INSURANCE?

1. A Brief Survey of Deposit Insurance Programs Worldwide

From a global prospective, deposit insurance is a recent phenomenon. Of the sample of 50 deposit insurance systems studied by the IMF in 1999, nine were adopted in the 1960s, six in the 1970s, 17 in the 1980s, and 15 in the 1990s.⁵¹

In spite of its short and controversial history,⁵² deposit insurance has been implemented in almost all developed countries and most developing countries. At the regional level, the EC adopted its Directive on Deposit Guarantee Schemes on May 30, 1994 “to ensure a harmonized minimum level of deposit protection wherever deposits are located in the Community.”⁵³ Member states are required to develop such schemes in compliance with the Directive. At the international level, there has been an increased use of government-sponsored deposit insurance, pushed by the World Bank and the IMF.⁵⁴ By the end of 1995, among all the countries in the world, there are only a little bit more than 70 countries, all but one from the developing countries, offering no deposit insurance scheme.⁵⁵

2. Pros and Cons of Deposit Insurance

Deposit insurance must be the most controversial component of a banking safety net. There are arguments either in favor of or against deposit insurance.

⁵¹ See Garcia, G, *supra* note 13, at 8 and Chart 1.

⁵² Some authors even argue that with an effective LOLR, it might not be necessary to have deposit insurance. See Wood, Geoffrey E., *supra* note 40, at 75-6.

⁵³ Directive 94/19/EC on Deposit Guarantee Schemes.

⁵⁴ The World Bank frequently advises the establishment of deposit insurance programs as a component of adjustment programs. Another international organization, the IMF provides technical and policy-based advice on system designs. See, e.g., Miller, Geoffrey P., ‘Deposit Insurance for Economies in Transition’ in Lastra, R. M., Schiffman, Henry N. (eds.), *Bank Failures and Bank Insolvency Law in Economies in Transition*, 37, at 37-8 (1999).

⁵⁵ See, e.g., Goldstein, Morris & Turner, Philip, *Banking Crises in Emerging Economies: Origin and Policy Options*, BIS Economic Paper No. 46, 30 (1996).

Arguments for Deposit Insurance Those in favor of deposit insurance argue on the basis of the necessity to prevent bank runs, consumer protection, and fair competition between large and small deposit-taking institutions.

The principal justification for deposit insurance is that it reduces the danger of bank runs and bank panics.⁵⁶ Deposit insurance helps build up public confidence in the safety of bank deposits and thus promote the stability of individual banking institutions.⁵⁷ In this sense, deposit insurance is supplementary to the capital adequacy requirements (focusing on solvency) and LOLR (purposed to help banks facing liquidity problem).⁵⁸

In terms of consumer protection, a deposit insurance scheme is designed to minimize or eliminate the risk that depositors placing funds with a bank will suffer a loss. It thus offers protection to the deposits of households and small business enterprises, which may represent life savings or vital transaction balance.

A related effect of deposit insurance that may be important in some financial systems is that it levels the playing field to a degree for large and small institutions. Under a formalized deposit insurance program, all institutions have access to depositor protection in the amounts specified by the coverage rules.⁵⁹

Finally, the explicit rules of a deposit insurance program provide added certainty regarding the resolution process for failed banks. A properly balanced deposit insurance program can provide order in winding up the affairs of a failing institution, and can thus facilitate the establishment of an effective exit mechanism.⁶⁰

Arguments against deposit insurance There are numerous arguments against deposit insurance. With regard to deposit insurance as an antidote to runs and panics, it is argued that bank runs are not totally bad. Indeed, some economists argue that bank runs have beneficial

⁵⁶ E.g., in the U.S., it was because of the failure of the Federal Reserve System in preventing the financial crisis of the early 1930s that the Congress established the Federal Deposit Insurance Corporation in 1933. See, e.g., Sinkey, Joseph F. Jr., 'Regulatory Attitudes toward Risk', in Aspinwall, Richard C. & Eisenbeis Robert A. (eds.), *Handbook for Banking Strategy*, 349 (1985).

In Canada the introduction of deposit insurance in 1967 followed a bank run on a sound institution, although prevention of bank runs was not the main focus of the legislation. See Schwartz, Anna J., 'Financial Stability and the Federal Safety Net', in Harif, William S. & Kushmeider, Rose Marie (eds.), *Restructuring Banking & Financial Services in America* (1988).

⁵⁷ See Ketcha, Nicholas J Jr., *supra* note 3, at 223. Ketcha argues that no amount of prudential supervision can provide protection against runs that is equivalent to deposit insurance. *Id.*

⁵⁸ See Dewatripont, Mathias & Tirole, Jean, *The Prudential Regulation of Banks* 59-60 (1994). Capital adequacy requirements and lender of last resort do not rule out panics when a bank becomes insolvent, if depositors fear that they will not be fully reimbursed in case of failure. Those two authors attributes the absence of bank runs of large shock in the US in late 1980s to the depositors' trust in the deposit insurance system. *Id.*

⁵⁹ See Ketcha, Nicholas J Jr., *supra* note 3, at 224.

⁶⁰ *Id.*, at 225.

monitoring effects: because bank managers can quickly and covertly substitute riskier asset with less risky assets; and the private market arguably imposes a particularly stringent form of discipline against managerial misconduct.⁶¹ In these authors' view, even a banking crisis, for all its costs, functions as a stringent form of marketplace discipline.⁶²

The strongest argument against deposit insurance is that it creates a severe moral hazard⁶³ on the part of insured banks. "Public deposit insurance encourages bank owners and managers (particularly in troubled banks) to take irresponsible or excessive risks than if bank deposits were not insured. It also encourages insured depositors and sometimes soothe bank creditors not to monitor the bank as carefully and diligently as they would without insurance."⁶⁴

The macro-economic consequences of deposit insurance are also used to oppose deposit insurance. It is argued that the insurer will have to pay out large claims to depositors of failed banks in the event of a banking crisis and such a situation may create a nearly irresistible urge to obtain the necessary funds through central bank borrowing and consequently creates a clear and present danger of inflation.⁶⁵

Another macro-economic effect of deposit insurance is that it can mask economic problems until those problems are so far advanced that they impose real costs on the economy. To the extent that deposit insurance removes a source of discipline on policy-makers, it creates a danger of poor economic policies in the future.⁶⁶ The final macro-economic effect of deposit insurance is that if the government faces a banking crisis, it may attempt to manipulate policy to reduce the government's liabilities.⁶⁷

3. Doctrine of Necessity

As shown above, there are no overwhelming arguments in favor of establishing deposit insurance. As Professor Geoffery Miller concludes, arguments for and against deposit

⁶¹ See, e.g., Calomiris C. W. & Kahn, C. M., 'The Role of Demandable Debt in Structuring Optimal Banking Arrangements', 81 *American Economic Review* 497 (1993).

⁶² See, e.g., Miller, Geoffery P., *supra* note 54, at 41.

⁶³ The term "moral hazard" — drawn from the nineteenth century insurance practice — refers to the fact that a party who is insured against a risk may fail to take adequate precautions against the harm occurring. *Id.*, at 42.

⁶⁴ See Lastra, Rosa Maria, *supra* note 4, at 130.

⁶⁵ See, e.g., Miller, Geoffery P., *supra* note 54, at 43.

⁶⁶ *Id.*

⁶⁷ Although there is no direct evidence to this effect, it appears possible that the Federal Reserve kept American interest rates low during the late 1980s and early 1990s in part to reduce the costs of the S & L debacle. *Id.*, at 43-4.

insurance are finely balanced.⁶⁸ Then why have so many countries chosen to adopt a deposit insurance system?

The doctrine of necessity might be able to offer a good explanation, although not necessarily satisfactory. International experience shows that in the case of a severe banking crisis, a government will have no choice but to bail out depositors even if the government has made no explicit promise to do so. In country after country, governments that have closed banks and attempted to allow depositors to incur losses only found they themselves to extend assistance subsequently in order to deal with political outrage and prevent a widening of the crisis.⁶⁹ In developing or transitional economies, even if there is no explicit deposit insurance, there is often a form of implicit insurance with much the same effect, albeit subject to a degree of uncertainty as to the size or scope of the guarantee.⁷⁰

The up and down of deposit insurance in Argentina shows clearly how the doctrine of necessity works. Before 1991, there operated an explicit deposit insurance system in the country. In 1991-2, Argentina reversed course by repealing its deposit insurance program. It was stated that under no circumstances would the government rescue a failing bank. Yet this announcement seemed to go by the wayside during Argentina's financial crisis of 1995-1996. Political pressures from bank failures and economic instability became so severe that theory had to yield to necessity: a new deposit insurance system was established immediately after the crisis.⁷¹

4. To Replace the Implicit Government Guarantee in China with Explicit Deposit Insurance

(i) *China's Current Government Implicit Guarantee*

To date, there is no explicit deposit insurance in China, despite the general provisions that to encourage household deposit and savings, the government shall protect the ownership and other legitimate rights on household deposit and savings.⁷² The Commercial Banking Law provides that "A commercial bank shall guarantee the payment of the principal and interests

⁶⁸ *Id.*

⁶⁹ See Talley, S. H. & Mas, I., *Deposit Insurance in Developing Countries*, the World Bank Policy Research and External Affairs Working Paper WPS 548, 4 and note 3 (1990).

⁷⁰ See, e.g., Miller, Geoffery P., *supra* note 54, at 49.

⁷¹ *Id.*, at 50.

⁷² Regulations Governing Deposit and Savings [chuxv guanli tiaoli], promulgated by the State Council on December 11, 1992 (hereinafter referred to as "Regulations Governing Deposit and Savings"), art. 5.

of every deposit and shall not delay or refuse the payment thereof.”⁷³ The law also gives priority to individual depositors when banks go bankrupt.⁷⁴

But in fact, China has long been carrying out an implicit government guarantee.⁷⁵ Although the government has made no legally binding commitment to fully repaying the household deposits of ailing institutions, such commitments were made on the closure of China Agricultural Trust and Investment Company, Hainan Development Bank and other financial institutions.⁷⁶ In China’s first financial institution bankruptcy case — the Guangdong International Trust and Investment Corporation (GITIC) case, GITIC’s individual depositors were fully paid by Guangdong province government in their deposit principals.⁷⁷

In the most recent closure of three Wuhan financial institutions that allegedly violated regulations and consequently were not able to repay their debts on time, the PBOC Wuhan branch promised that individual creditors would be paid fully in principals and interests.⁷⁸ The government’s main concern, obviously, is the social stability.

(ii) *Arguments for and against Government Implicit Guarantee*

There are arguments in favor of implicit deposit insurance. Implicit insurance may not cost taxpayers as much money if the bank can be stabilized without a full-scale deposit payout.⁷⁹

⁷³ The Law of the People’s Republic of China on Commercial Banks, adopted at the 13th Session of the Standing Committee of the Eighth National People’s Congress on March 18, 1995, and effective as of July 1, 1995 (hereinafter referred to as “the Commercial Banking Law”), art. 33. *See also* Regulations Governing Deposit and Savings, *supra* note 72, art. 14.

⁷⁴ The Commercial Banking Law, *supra* note 73, art. 71. Paragraph 2 of this article reads as follows:

At the time of bankruptcy liquidation, a commercial bank shall give priority to paying the principal and interests of savings deposits after paying the liquidation fees and its staff wages and labor insurance fees in arrears.

⁷⁵ *See, e.g.,* Lau, Lawrence J., ‘The Macroeconomy and Reform of the Banking Sector in China’ in *Strengthening the Banking System in China: Issues and Experience*, BIS Policy Papers No. 7, 59, at 74 (October 1999).

⁷⁶ In all these cases, individual depositors were fully paid off. *See* Chinaonline, ‘Gitic Bankruptcy Follows Four China Financial Institution Closures Since 1996’, available at ‘http://www.chinaonline.com/top_stories/today_b9011326.html’.

⁷⁷ It was announced at the GITIC creditors’ meeting on January 10, 1999 that, with the approval of the Guangdong Provincial People’s Government, the Guangdong Provincial Finance Department would transfer funds to the BOC for the purpose of repaying the principal owing to GITIC’s individual depositors; once repayment had been made, the BOC Guangdong Branch would, on behalf of the Guangdong Provincial Finance Department, subrogate to the rights of the individual depositors and register the claims as an ordinary creditor with the liquidation committee established by the People’s Court. On January 11, 1999, the BOC issued a public notice giving effect to the above arrangement. *See* Lam, Joseph, ‘The Insolvency of GITIC’, *J.I.B.L* No. 6, 193, at 193 & note 2 (1999).

⁷⁸ *See* Chinaonline, ‘Bankers’ Hours Just Got Shorter: Central Bank Shuts Down Three Wuhan Financial Institutions’ (July 11, 2000), available at ‘<http://www.chinaonline.com/topstories/000711/1/c00071008.asp>’.

⁷⁹ *See, e.g.,* Miller, Geoffrey P., *supra* note 54, at 51.

Moreover, implicit deposit insurance does not require that depositors be paid. The uncertainty about the amount of coverage and the speed with which the payments will be made introduces “constructive ambiguity” into the system and retains a certain amount of market discipline.⁸⁰

The arguments against implicit deposit insurance are more compelling, however. First, as discussed before, in the context of widespread banking disruption, the political pressure of angry citizens demanding to be paid will make it necessary as a practical matter to protect depositors even if the government has made no explicit promise to do so. Second, the implicit deposit insurance guarantee carries with it the danger that the government will not commit itself to supervising banks properly in order to prevent losses in the first place.⁸¹ This hands-off approach gives the government greater flexibility. But, the resulting level of supervision may be inappropriate low.⁸² Last but not least, an implicit guarantee cannot be limited. It is impractical for the government to announce on the one hand that it is not insuring bank deposits, while on the other hand set a ceiling for its guarantee. In this sense, an implicit deposit guarantee can end up costing more than an explicit guarantee because the implicit guarantee often means a 100% pay-out.⁸³

(iii) *Conclusion: China Should Replace the Current Government Implicit Guarantee with Explicit Deposit Insurance*

In addition to the above arguments against implicit government guarantee, there is another argument against the implicit government guarantee in China. The implicit government guarantee in China, because it is based on the State-ownership of most of the banks, has given State banks competitive advantages over non-state-owned banks. The closing down of the Hainan Development Bank and GITIC, for example, triggered a shift of tens of billions of savings from the non-state-owned banks to the “big four”, although the financial situation of the “big four” is at least no better than most of the smaller banks.⁸⁴ It is therefore necessary to have an explicit deposit insurance system that gives depositors in medium and small-sized

⁸⁰ See Demirguc-Kunt, Asli, *supra* note 1.

⁸¹ Indeed, the government may have an incentive affirmatively to avoid strict supervision, since if the government did supervise banks and represented to the public that banks were under government regulation, arguments in favor of a payout would be greatly strengthened.

⁸² See, e.g., Miller, Geoffery P., *supra* note 54, at 51.

⁸³ *Id.*

banks some guarantee so that these medium and small-sized banks will not be too disadvantaged to compete with their large counterparts.

With regard to the two arguments in favor of implicit government guarantee, the author would like to claim that these arguments do not exist in China. The implicit deposit insurance, instead of enhancing market discipline, may also provide an expectation of government bailout. It therefore fails in the view of those who favor stricter market discipline. Besides, because the government have to compensate individual depositors whenever a financial institution is closed,⁸⁵ it is hard to say that the implicit guarantee would save the government any money. The Chinese government has recognized the problem with its implicit guarantee and has given signal to the market by the GITIC case that the government cannot always be counted on to rescue troubled financial institutions.

The conclusion is obvious here: China should substitute its current implicit government guarantee with an explicit and limited deposit insurance program. It is reported that China plans to establish a deposit insurance scheme to prop up fragile public confidence in the financial sector⁸⁶ and enhance the commercial independence of Chinese banks.⁸⁷

B. ISSUES TO BE CONSIDERED AND PRINCIPLES TO BE FOLLOWED IN DESIGNING CHINA'S DEPOSIT INSURANCE SYSTEM

1. Issues to Be Considered

There are no fixed models for a deposit insurance program. The funding, coverage and administration of deposit insurance vary greatly across countries.⁸⁸

⁸⁴ See, e.g., Pu, Yonghao, 'Why China Won't Be Asia's Next Basket Case Economy', available at http://www.chinaonline.com/commentary_analysis/ac_c9041941.html.

⁸⁵ Because of the lack of deposit insurance scheme, when the net realizable assets of a closed financial institution are not enough to repay the principal of saving deposit of individuals, shareholders, local governments, or the central bank usually have to subsidize the repayment. See Xie, Ping, *supra* note 30, at 127.

⁸⁶ Although there is no contagious bank run in China, there have been reports about isolated bank runs. For example, it was reported that in April 1999, an Internet rumor about cash problems at the Zhengzhou branch of the Bank of Communications triggered a one-day bank run in which about RMB900m in savings was withdrawn. See, e.g., 'China Bank Reform', *Far E. Econ. Rev.*, 74 (1999); and also Chinaonline, 'Trial Opens for 3 Accused of Spreading Rumors about the Bank of Communications' (June 30, 2000), available at <http://www.chinaonline.com/topstories/0006301/1/C00062910.asp>.

⁸⁷ See, e.g., Harding, James, 'China Plans Savings Protection Scheme', *Fin. Times* (April 28, 1999).

⁸⁸ One of the IMF working paper surveys 50 deposit insurance systems worldwide and finds that 41 of 50 schemes are compulsory. A substantial number of the systems surveyed exclude particular types of deposit: 12 exclude foreign currency deposits, 36 do not cover inter-bank deposits, and 8 guarantee only household deposits. Thirty-eight systems maintain an ongoing fund, whereas nine impose ex post levies. Thirty-nine of the

A World Bank working paper observes a wide disparity among deposit insurance schemes, varying along dimensions such as: (1) whether the insurance is implicit or explicit; (2) the type of institutions covered; (3) public vs. private sponsorship; (4) compulsory vs. voluntary systems; (5) single vs. multiple funds; (6) amount and limits of coverage; (7) types of deposits covered; (8) methods of financing coverage; (9) methods for determining premium assessments; (10) assessment levels; (11) investment policies; (12) standards for admission and termination; (13) failure resolution devices; and (14) organization arrangements.⁸⁹ These are actually dimensions of a deposit system and should be considered one by one in designing a country's deposit insurance system.

2. Principles for Designing a Deposit Insurance System

In designing China's deposit insurance system, three principles must be followed. First, the deposit insurance system must be established by legislation, *i.e.*, legislation must be adopted to provide for the organization, coverage and funding of the deposit insurance system. Second, in designing the organization coverage and funding of deposit insurance system, caution must be taken to mitigate or avoid the moral hazard problem inherent with the deposit insurance system. Third, the deposit insurance system must be in harmony with China's existing financial system.

(i) *The Explicit Deposit Insurance Should be Established by Legislation*

As discussed above, there are several problems with the government implicit guarantee. The explicit deposit insurance guarantee can eliminate or mitigate these problems because the government is forced to take some degree of responsibility in its financial planning for the costs of the contingent liability, and because the government is likely to behave more

50 systems charge premiums to covered banks. Forty-three systems limit coverage in one form or another, but only 10 systems utilize co-insurance to combat moral hazard. Forty-six of the 50 systems are privately funded, although most of these receive official help at one time or another. Eleven systems are privately administered, 23 are run by the government, and 14 are jointly operated. See Garcia, G, *supra* note 13.

⁸⁹ See Talley, S. H. & Mas, I., *supra* note 69.

responsibly in its supervision policies.⁹⁰ Most significantly, the explicit deposit insurance can be explicitly limited.⁹¹

These advantages, however, cannot materialize without proper predetermined rules and procedures. Legislation is therefore essential, as Chinese scholars have also recognized.⁹²

(ii) *The Deposit Insurance System Should Be Designed in as Incentive-compatible a Way as Possible*

The moral hazard problem of deposit insurance has been extensively discussed. To mitigate the moral hazards inherent to deposit insurance, market discipline needs to be introduced to limit or reduce the risks and costs of a bank failure to the insurer. Such discipline can be exercised by:⁹³ (1) setting a ceiling of protection; (2) introducing risk-based insurance premiums instead of a flat rate that does not consider risk taken; (3) establishing adequate firewalls so as not to subsidize trading activities; (4) raising bank capital requirements, which act as a deductible; and/or (5) introducing a system of coinsurance or a system of private insurance.

It would be impracticable to include all these features into China's deposit insurance program at once, given the fact that they are not even totally contained in any single deposit insurance scheme in the world. The deposit insurance system in China, however, should include as many as possible these incentive-compatible factors.

(iii) *The Deposit Insurance System Should Be in Harmony with the Existing Financial System*

⁹⁰ See Miller, Geoffery P., *supra* note 54, at 51.

⁹¹ Making deposit insurance explicit is the only practical way to ensure that it is also limited in amount. See Macey, J. R. & Miller, G. P., 'Deposit Insurance, the Implicit Regulatory Contract, and the Mismatch in the Term Structure of Banks' Assets and Liabilities', 12 *Yale Journal on Regulation* 1 (1995).

⁹² See Chen, Yin, 'Basic Ideas on China's Deposit Insurance System [jianli woguo chunkun baoxian zhidu de jiben gouxiang]', *Economic Science* (jingji kexue) No. 4, 25, at 25 (April, 1999). That author suggests that the law should provide for the operational procedures of deposit insurance system, the constitution of the deposit insurance corporation, the main function of deposit insurance corporation and its inspection powers, the premium rate and how to deal with problem institutions, etc. The author even suggests that the bill should be drafted jointly by the PBOC and the Ministry of Finance. *Id.* at 25-6.

⁹³ See, e.g., Lastra, Rosa Maria, *supra* note 4, at 133; and also Benston, George J. & Kaufman, George G., 'Regulating Bank Safety and Performance', in Harif, William S. & Kushmeider, Rose Marie (eds.), *Restructuring Banking & Financial Services in America* (1988).

The logic behind this principle is obvious. Deposit insurance, as part of a country's financial system, can only be established and operated within that specific system. This rule has special meaning in China. China is now reshuffling its financial system as part of its efforts to transform the planned economy to market economy. Attention needs to be paid to this transitional feature in designing China's deposit insurance system.

C. DESIGNING CHINA'S DEPOSIT INSURANCE SYSTEM

1. Organizational Structure, Coverage and Funding of Deposit Insurance⁹⁴

(i) *The Organizational Structure*

The organizational structure of deposit insurance denotes the insurer's relationships with other government agencies (especially the banking regulators) and with the insured. Theoretically, an independent deposit insurer is necessary because the deposit insurer is vulnerable to political pressures, especially when there is a large-sized bank disruption. An independent authority is in the best position to resist such pressures. However, it must be recognized that establishing a separate authority for deposit insurance requires careful attention to the balance of powers among various banking authorities, given the incentives towards conservatism on the part of the insurer.

Another related issue is whether the deposit insurer should also have direct supervisory authority. In cases where the insurer is not also a bank supervisor, the arrangement must provide the insurer with the necessary information on the current condition and operations of all insured institutions. When the deposit insurer also has supervisory responsibilities, the internal structure must provide for appropriate balance between these functions. In China, this issue becomes whether the insurer should be subordinated to the PBOC or independent from the PBOC. If the insurer is subordinated to the PBOC then it is not necessary to authorize it with supervisory powers and the insurer will not have problem in obtaining information about the insured.

There is suggestion in China that a Deposit Insurance Company be established by adopting a Deposit Insurance Company Law.⁹⁵ That author suggests that the Company

⁹⁴ The discussion in this section draws heavily from Ketcha, Nicholas J Jr., *supra* note 3 and Demirguc-Kunt, Asli, *supra* note 1.

should not be a government agency, but a special policy financial institution, with the authority to inspect and examine the depositary institutions on the basis of deposit insurance contracts.⁹⁶ According to that author, the Company would collect premiums from deposit-taking institutions, manage the deposit insurance fund, deal with problem institutions, and would pay off depositors when a deposit-taking institution is closed.⁹⁷

The current author agrees with these suggestions except that the insurer, from this author's point of view, should be a government agency rather than a special policy financial institution. Given that the government back-up is essential for the public confidence in the insurer, and that without a wide branch network, it would not be possible for the insurer to carry out efficient examination and inspection on depositary institutions nationwide,⁹⁸ it might be a good idea to make the deposit insurance company part of the PBOC, or at least closely affiliated to the PBOC.

(ii) *The Scope of Deposit Insurance*

The scope of deposit insurance denotes the scope of activities that should be brought under an insurance protection scheme. It is important to avoid including activities unnecessary, given the potential conflict between deposit insurance and market discipline.

The attempt to minimize unwarranted expansion of the deposit insurance safety net raises questions about whether banking organizations should conduct non-banking activities, and what should constitute a banking activity for the deposit insurance purpose. Since commercial banks in China are now prohibited from engaging in non-banking activities,⁹⁹ these questions are not urgent for policy-makers in China, at least for this moment.

Problem remains, however, about whether the deposit insurance should protect deposits of all types, or be limited to protect individual depositors only. Of the deposit insurance scheme surveyed by Garcia, 27 exclude all or some foreign currency deposits, 45

⁹⁵ See Chen, Yin, *supra* note 92, at 25.

⁹⁶ *Id.*, at 27.

⁹⁷ *Id.*, at 26.

⁹⁸ It has been stressed that if a deposit insurance scheme is established, the agency needs adequate powers — “The creation of deposit insurance schemes with insufficient resources or legal powers to deal with the problems can be disastrous. These institutions give the illusion of a responsible agency without the substance. Deposit protection agencies in Kenya and the Philippines were not provided with sufficient resources to deal with the rising level of bank problems, and the end the rescuer had to be rescued.” See Sheng A., *Bank Restructuring: Lessons from the 1980s*, 47 (World Bank, 1996).

⁹⁹ The Commercial Banking Law, *supra* note 73, art. 43.

do not cover inter-bank deposits, and 16 guarantee only, or mainly, household deposits.¹⁰⁰ The current author would suggest that the deposit insurance in China only protects the individual depositors, including both their RMB and foreign currency deposit savings in depositary institutions within the administrative territory of the PBOC,¹⁰¹ in consistency with the scope of China's current government implicit guarantee.

(iii) *The Deposit Insurance Coverage*

Striking the right balance is critical in establishing the coverage limit for insured instruments. The coverage must be sufficient to prevent destabilizing bank runs, but not so extensive as to eliminate all effective market discipline on banks' risk-taking.

The basic principle here is that to constrain excessive bank risk-taking, the formal insurance coverage should not be complete. The situation worldwide is that most countries specify an upper limit to the size of the deposit balance that is officially protected, some countries provide only co-insurance, such as protection for 80% of a deposit account balance;¹⁰² while some countries employ both the ceiling and coinsurance.¹⁰³ These arrangements are important because they provide an incentive for all depositors to monitor bank risk-taking by exposing them to small losses.

The coverage, however, must be sufficient to prevent destabilizing bank runs. It is intuitive that deposit insurance coverage limits should bear some relationship to measures of income and wealth, so as to provide a relatively constant amount of protection to savers. The IMF uses one or two-times per capita GDP as the general rule in advising countries on appropriate limits for deposit insurance coverage.¹⁰⁴ China might be able to follow this rule in deciding the coverage of deposit insurance. In one of the reported financial institution closure cases — the closure of 14 urban credit cooperatives in Beihai city, Guangxi Zhuang Autonomous Region,¹⁰⁵ a ceiling of RMB10000 was set to repay each deposit account, with

¹⁰⁰ See Garcia, G, *supra* note 13, at 10.

¹⁰¹ See Chen, Yin, *supra* note 92, at 29. The administrative territory of the PBOC excludes Hong Kong and Macao.

¹⁰² See Ketcha, Nicholas J Jr., *supra* note 3, at 229.

¹⁰³ E.g., in the UK, the deposit protection scheme covers 75% of the first £20000 of sterling deposits made with an "authorized institution." See, e.g., Lastra, Rosa Maria, *supra* note 4, at 131.

¹⁰⁴ See Ketcha, Nicholas J Jr., *supra* note 3, at 229.

¹⁰⁵ For details of the case, see Liu, Shiyu, 'China's Experience in Small and Medium Financial Institution Resolution' in *Strengthening the Banking System in China: Issues and Experience*, BIS Policy Papers No. 7, 298, at 300-1 (October 1999).

the remaining debts to be paid in installments and in proportion depending on the proceeds from the sale of assets.¹⁰⁶

This author would like to suggest that the law fix both a floor and a ceiling for compensation to household depositors. When the total amount of deposit savings held by an individual with a closed institution is under the floor, the depositor should be fully compensated. If the aggregate deposit savings of an individual with a closed institution exceed the floor, the depositor would be fully compensated for his/her deposit savings up to the floor but can only be paid a certain percentage of the remaining claims. Moreover, the aggregate compensation an individual can receive from the insurer shall be “ceiled”.¹⁰⁷

(iv) *Funding the Deposit Insurance*

The majority of deposit insurance systems operate through a stand-alone fund against which draws are made from time to time as banks fail.¹⁰⁸ With regard to the funding of a deposit insurance fund, at the two extremities are a public-funded deposit insurance system and a stand-alone deposit insurance fund financed solely through premiums paid by insured institutions.¹⁰⁹ A combination of the two can also be considered, *i.e.*, a stand-alone deposit insurance fund financed through premiums paid by insured institutions supplemented by public money.

One benefit of establishing a stand-alone deposit insurance fund financed solely through premiums paid by insured institutions is that these institutions may perceive a direct stake in the financial health of the insurance system, providing motivation for them to scrutinize deposit insurance operations and maintain industry self-policing.¹¹⁰ It must be stressed here, however, it is the financial capacity of the insuring entity that lends credibility to a deposit insurance guarantee, and thereby removes much of the incentive for bank runs. That explains why in many large economies the taxing and borrowing authority of the

¹⁰⁶ *Id.*, at 301. The RMB10000 ceiling guaranteed the full payment of small depositors (accounting for roughly 60% of all depositors). *Id.*

¹⁰⁷ See also Chen, Yin, *supra* note 92, at 30.

¹⁰⁸ See Talley, S. H. & Mas, I., *supra* note 69, at 13.

¹⁰⁹ *E.g.*, in the UK, the deposit protection scheme is financed through a levy on all authorized institutions in proportion to their deposit base. See, *e.g.*, Lastra, Rosa Maria, *supra* note 4, 131.

¹¹⁰ See Ketcha, Nicholas J Jr., *supra* note 3, at 231.

national government provides the maximum financial capacity and government-provided deposit insurance.¹¹¹

In a country like China where banks and depositors have gotten so used to implicit government guarantee, and given the weak capital situation of most Chinese banks,¹¹² the author would not suggest that China choose to fund its deposit insurance scheme solely through premiums paid by banks. The banks, however, should pay premiums which they can afford. In other words, the government would have to financially and administratively support the scheme at least for its initial stage. A stand-alone deposit insurance fund financed through premiums paid by insured institutions supplemented by public fund might be an optimal choice for China.¹¹³

2. Deposit Insurance Premiums

A simple and relatively easy-to-implement system for assessing deposit insurance premiums is to assess all insured institutions at a given rate per unit of deposit or per unit of other assessment base that reflects the total coverage provided. Such a pricing system is aimed at maintaining adequate financial capacity for the insurer, and leaves the task of controlling moral hazard to the supervisory process and the market.

This flat-rate system was employed in the US for almost 60 years and was widely criticized because the premiums were not risk related and therefore provided incentives to insured institutions to invest in risky projects and contributed to economic inefficiency by the subsidy to the borrowers.¹¹⁴ The debates and criticisms eventually led to the introduction of a risk-related premium system in the US.

Ideally, risk-based pricing of deposit insurance would influence bank decision-making well ahead of supervisory sanctions, providing incentives *ex ante* for institutions to avoid undue risk-taking. The implementation of the risk-based pricing, however, remains a

¹¹¹ *Id.*, at 225-26.

¹¹² It was estimated that if the “big four” in 1995 had made deposit insurance contributions of only 0.2% of their deposits, their reported pre-tax profits could have been reduced by one-third. See Lardy, Nicholas R., ‘The Challenge of Bank Restructuring in China’ in *Strengthening the Banking System in China: Issues and Experience*, BIS Policy Papers No.7, 25 (October 1999).

¹¹³ *But Cf.* Chen, Yin, *supra* note 92, at 27, where that author suggests that the size of the deposit insurance fund is not important because the deposit insurance corporation has the back up of the government. Chen proposes that the deposit insurance corporation needs only RMB1bn registered, capital, with RMB500m from the PBOC and the Ministry of Finance and other RMB500m contributed by the deposit-taking institutions. *Id.*

problem. Charging risk-rated premiums involves a reliance on regulators to measure bank risk-takings. Using market indicators to measure this risk would be difficult since market perceptions of bank risk would incorporate existing safety net policies.

Indeed, in the U.S., where insurance premiums are risk-rated, the range of premiums charged is very small, with more than 90% of the banks qualifying for the lowest assessment rate of zero.¹¹⁵ Such practices question the efficacy of controlling risk through risk-rated premiums. Actually, only 11 countries had adopted the risk-based pricing by 1999. And, none of these systems has gone through an entire banking cycle and must be considered as still in the experimental stage.¹¹⁶

Given the difficulties in implementing the risk-based pricing system, this author would recommend that China have a flat premium at first.¹¹⁷ The premium, however, should be adjustable according to the changing situation.¹¹⁸

3. Membership of the Deposit Insurance System

Currently, deposit-taking institutions in China include the “big four”, other domestic commercial banks, urban credit cooperative, rural credit cooperatives, foreign bank branches, and postal savings.¹¹⁹ There are three proposals regarding the membership of the deposit insurance system. Some propose a deposit insurance system covering only urban and rural credit cooperatives, while others propose a deposit insurance system covering all deposit-taking institutions in China. Between these two is a proposal that the “big four” should be exempted from joining the deposit insurance system.¹²⁰

The current author would not discuss here whether foreign bank branches should be included in the deposit insurance system. Respecting other deposit-taking institutions,

¹¹⁴ See, e.g., Schwartz, Anna J., *supra* note 56, at 50; Benston, George J. & Kaufman, George G., *supra* note 93; and also Peterson, Manfred O., ‘Regulatory Objectives and Conflicts’, in Aspinwall, Richard C. & Eisenbeis Robert A. (eds.), *Handbook for Banking Strategy*, 337-38 (1985).

¹¹⁵ In the United States, the Federal Deposit Insurance Corporation in 1995 cut premiums to zero for well-capitalized commercial banks. But a few weaker banks paid premiums as much as 0.27% of deposits. See Wilke, John R., ‘FDIC Premiums for Most Banks Eliminated to Zero’, *Wall Street Journal*, A4 (November 15, 1995).

¹¹⁶ See Ketcha, Nicholas J Jr., *supra* note 3, at 233.

¹¹⁷ But Cf. Chen, Yin, *supra* note 92, at 29, where that author proposes a risk-adjusted premium system. *Id.*, at 32.

¹¹⁸ E.g., in Japan, where falling stock and land prices weakened the banking system in the first half of 1990s, the Ministry of Finance in late 1995 raised annual deposit insurance contribution six-fold, from 0.012% to 0.084% of deposits. See Baker, Gerard, ‘Insurance Fees to Leap for Banks in Japan’, *Fin. Times* (December 23, 1995).

¹¹⁹ Regulations Governing Deposit and Savings, *supra* note 72, art. 4.

¹²⁰ See, e.g., Chen, Yin, *supra* note 92, at 28.

however, the author prefers a system covering all the deposit-taking institutions, including the “big four”,¹²¹ on the basis of the following three arguments.

First, the “adverse selection” problem can happen if the membership in the insurance system is voluntary and the premium charged is not related to risk. Because such an insurance is much more valuable for weaker banks and costly for stronger ones, stronger banks tend to remain outside of the insurance scheme to avoid having to subsidize their weaker counterparts. A risk-related premium system can address the adverse selection problem, but to the extent that risk-related premiums may not fully reflect all the risks posed by insured institutions, compulsory membership still may be warranted.¹²²

Second, the argument that it is unnecessary for the “big four” to join the deposit insurance system because they are wholly State-owned and have full backup from the government is losing its validity. With the deepening of the financial reform, the “big four” will sooner or later have to be independent from the government. Besides, with China’s entrance of the WTO, the “big four” will face more and more competition pressures from transnational banks backed by deposit insurance in their home countries.

Third, without the joining of the “big four”, the deposit insurance system in China will not be able to be self-supported. The “big four” banks had about 63% of the deposit and loan market of the whole country in the year 1998. That means if they do not join the deposit insurance scheme, the scheme would not be able to be sufficiently funded.

4. Summary

Following the principles set in Section B, key components of a deposit insurance system are considered in this section on the basis of China’s particularities. It is recommended that legislation be passed to establish a Deposit Insurance Company, providing deposit insurance to deposits in all depositary institutions in China (including the “big four”). The Company should have the authority to inspect and examine the insured institutions. The Company would collect premiums from deposit-taking institutions at a flat rate adjustable to the changing situation, would manage the deposit insurance fund and deal with problem institutions, and would pay off depositors when a deposit-taking institution fails. The company should be affiliated to the PBOC. Respecting the scope and coverage of deposit

¹²¹ *Id.*, at 28-9, where that author argues for a deposit insurance system including the “big four”.

¹²² See, e.g., Ketcha, Nicholas J Jr., *supra* note 3, at 232.

insurance in China, it is recommended that the deposit insurance only protect individual depositors, with “floor” and “ceiling” fixed for compensation to a single depositor.

D. TIMING THE INTRODUCTION OF DEPOSIT INSURANCE

Timing the introduction of deposit insurance appropriately is not an easy job. On the one hand, “starting a deposit insurance scheme while the banking system is unsound” is regarded as a “departure from best practice” as it is likely to lead to a scheme with very wide coverage.¹²³ On the other hand, restoring public confidence and avoiding runs are important elements in restoring the health of the banking system, which would argue for an earlier introduction.¹²⁴

It is far beyond the author’s charge for this study to suggest a timetable of introducing deposit insurance in China. The point the author would like to make here is that, after an explicit deposit insurance system is introduced, the government should adhere to its commitment to pay out only those deposits that fall within the terms of the guarantee and no others when the deposit insurance system is put to the test the first time.¹²⁵

IV. INSOLVENCY RESOLUTION¹²⁶

A. GENERAL INTRODUCTION

Effective and timely resolution of insolvencies is probably one of the most important elements for a banking safety net. The timely resolution of failed institutions would reinforce systemic stability, promote public confidence in the system, and would restore liquidity to the economy.¹²⁷ The way a bank is handled when failure is imminent affects the willingness of potential lenders to lend to the troubled bank, the willingness of the supervisory authority

¹²³ See, e.g., Garcia, G, *supra* note 13, at 10.

¹²⁴ See Hawkins, John & Turner Philip, *supra* note 29, at 51.

¹²⁵ See, e.g., Miller, Geoffery P., *supra* note 54, at 52. The first time is important, because if the government fails to stand behind its commitment the first time, it may never be able to do so again. On the other hand, if the government does hold firm in the face of the political pressure, then its commitment gains credibility for the future. *Id.*

¹²⁶ The strategies discussed in this section are mainly options to deal with individual bank failure in a sound economy, and is different from the strategies dealing with a systemic crisis discussed in Chapter One. Closure and liquidation, for example, is discussed both here and in Chapter One, but it bears different meanings. In Chapter One, we are talking about closing and liquidating at large size, while here we focus on issues related to the closure and liquidation of individual banks.

to intervene, and the willingness of the bank managers to act efficiently if they stand a chance of keeping their jobs under some forms of failure resolution.

Excluding the regulatory forbearance (which has been discussed in Chapter One), basic regulatory options to deal with a failed bank might include closure and liquidation (deposit payoff), a rescue package or open bank assistance, merger and take over (*e.g.*, purchase and assumption), and bridge bank.¹²⁸ To date, all these alternatives have been applied in some form, in China,¹²⁹ although the 1995 Commercial Banking Law¹³⁰ only provides briefly for the management take-over (a variation of bridge bank) and liquidation (including bankruptcy) of commercial banks.

B. CLOSURE AND LIQUIDATION (DEPOSIT PAYOFF)

Closure and Liquidation is the legal process whereby the assets of an institution are sold and its liabilities are settled to the extent possible and its license is withdrawn. The bank closure can be voluntary or forced, within or outside general bankruptcy procedures, and with or without court involvement. In liquidation, assets are sold to pay off the creditors in the order prescribed by the law. If there is deposit insurance, insured depositors are paid immediately under the insurance scheme.

Simple as it is, closure and liquidation is generally the most expensive solution, because the franchise value of the institution disappears and valuable bank-firm relationships are destroyed.¹³¹ Besides, bank closures may be difficult to organize without provoking asset stripping by owners, managers, and employers. Moreover, because loan collections may fall after a bank closure, closure may increase the ultimate cost of resolving the insolvency of the institution.¹³²

¹²⁷ See, *e.g.*, Ketcha, Nicholas J Jr., *supra* note 3, at 235-6.

¹²⁸ See Balino, Tomas J. T., Enoch Charles *et al.*, *supra* note 14, at 23 & box 3; and also Dewatripont, Mathias & Tirole, Jean, *supra* note 58, at 66-71.

¹²⁹ See Zhu, Jun, 'Closure of Financial Institutions in China' in *Strengthening the Banking System in China: Issues and Experience*, BIS Policy Papers No. 7, 304, at 307-9 (October 1999).

¹³⁰ The Commercial Banking Law, *supra* note 73, arts. 64-72.

¹³¹ Because of this, the liquidation is mainly applied to small banks. In the US, for example, only 25% bank failures in the 1970s and 1980s resulted in liquidations, none of the ten largest FDIC resolution transactions involved a payoff transaction. See Dewatripont, Mathias & Tirole, Jean, *supra* note 58, at 69-70. Dr. Lastra lists out another risk of the liquidation option, *i.e.*, confidence in the banking system may be seriously damaged, resulting in runs on other institutions. See Lastra, Rosa Maria, *supra* note 4, at 138.

¹³² See, *e.g.*, Enoch, Charles, *Interventions in Banks During Banking Crises: The Experience of Indonesia*, 2, the IMF Policy Discussion Paper (March 2000).

In China, most ailing financial institutions are closed out of the court system. So far, there is only one financial institution bankruptcy case.

1. Out of Court Liquidation: Voluntary Closure Vs. Administrative Closure

Currently, there are two ways to close a financial institution out of court in China: “voluntary closure” with debt repayment, and administrative closure with the PBOC withdrawing the problem institution’s business license. In both cases, liquidation will have to be carried out to repay deposit principals and interests, and other debts.

Respecting the voluntary closure, it is provided that when a commercial bank splits or merges with another one; or dissolves on reason for dissolution pursuant to the statute of the bank, it should submit an application to the PBOC with reasons for the dissolution and a plan for liquidation, including repaying the deposit principals and interests. Approval from the PBOC must be obtained before the bank can be dissolved.¹³³ After the approval of the PBOC, a liquidation term should be formed to conduct liquidation under the supervision of the PBOC.¹³⁴

Article 70 of the Commercial Banking Law provides for the administrative closure, which reads as follows:

When a commercial bank’s banking permit is revoked, the PBOC shall immediately form a liquidation group to conduct liquidation, formulate liquidation plan, and repay the principals and interests of deposits in time.¹³⁵

The voluntary closure does not have a lot to do with insolvency resolution. In the rest of this part, this author will focus on the administrative closure, which has been applied extensively by the PBOC to cope with failing financial institutions. From 1997 to 1998, the PBOC administratively closed 42 problem depository institutions, including one commercial bank (the Hainan Development Bank), 23 urban credit cooperatives and 18 rural credit cooperatives, and two trust and investment companies (China Agricultural Trust and

¹³³ The Commercial Banking Law, *supra* note 73, art. 69, paragraph 1.

¹³⁴ *Id.*, art. 69, paragraph 2.

¹³⁵ *Id.*, art. 70.

Investment Corporation, China Venture Investment Corporation) (see Table 4.1: Administrative Closure of Financial Institutions in China).¹³⁶

(i) *Legal Infrastructure for Administrative Closure*

Widely applied as it is, the administrative closure has not been provided in details under the current legislation. The main legal basis for administrative closure is relevant provisions in the Central Banking Law¹³⁷ and Commercial Banking Law.¹³⁸

Article 74 of the Commercial Banking Law lists 8 circumstances where the PBOC can revoke a commercial bank's banking permit:¹³⁹ (1) that the commercial bank issues financial bonds or borrows funds from outside China without official approval; (2) that the commercial bank deals in government bonds, or deals in or acts as agent in dealing in foreign exchanges without official approval; (3) that the commercial bank engages in trust investment and stock business in the country, or making investment in real estate not for its own use; (4) that the commercial bank makes investment in non-bank financial institutions or enterprises in the country; (5) that the commercial bank extends unsecured loans to related persons or extends loans against a collateral on more favorable conditions than to other borrowers of similar loans; (6) that the commercial bank submit false financial statements or financial statements which conceal important facts; (7) that the commercial bank refuses to accept the supervision and examination by the PBOC; or (8) that the commercial bank leases or lends banking permit to a third party.¹⁴⁰

With regard to non-bank financial institutions, the main legal basis is the Provisions on Financial Institution Administration¹⁴¹ promulgated by the PBOC in 1994. Accordingly,

¹³⁶ See Liu, Shiyu, *supra* note 105, at 299.

¹³⁷ The Central Banking Law, *supra* note 21, art. 31.

¹³⁸ The Commercial Banking Law, *supra* note 73, arts. 70, 74.

¹³⁹ *Id.*, art. 74.

¹⁴⁰ These unlawful practices, however, do not necessary lead to the revoking of banking permit. Only if the case is particularly serious or the offender fails to make correction within the specified time, the PBOC may order it to suspend business and make rectification and consolidation, or revoke its banking permit. *Id.*

¹⁴¹ Provisions on Financial Institution Administration [jinrong jigou guanli guiding], promulgated by the PBOC on August 5, 1994.

Table 4.1: Administrative Closure of Financial Institutions in China

Closed Institutions	Closing Date	Face Value on Closing Date (RMB: billion)	
		Assets	Liabilities
5 Urban Credit Cooperatives in Hainan	16/12/97	5.4	5.9
Hainan Development Bank	21/6/98	16.9	16.6
Urban Credit Cooperative in Luchuan, Guangxi	16/6/98	0.2	0.2
Hongye Urban Credit Cooperative in Qinghai	12/7/98	0	0
12 Urban Credit Cooperatives in Beihai, Guanxi	26/10/98	1.5	1.5
20 Urban Credit Cooperatives in Pingan, Guangdong	7/12/98	8.5	8.3
CATIC (China Agricultural Trust and Investment Corporation)	4/1/97	30.1	31.4
CVIT	6/98	10.3	10.4
Total		72.9	74.3

Sources: Table 2: Summary of Closure of Financial Institutions in China in Liu, Shiyu, ‘China’s Experience in Small and Medium Financial Institution Resolution’ in *Strengthening the Banking System in China: Issues and Experience*, BIS Policy Papers No. 7, 298, at 299 (October 1999).

the PBOC may close down a financial institution where:¹⁴² (1) it has seriously violated relevant laws, administrative rules, or State policies; (2) it has not commenced business within 90 days of obtaining its “Permit of a Financial Institution with the Status of a Legal

¹⁴² *Id.*, art. 42.

Person” or “Business Permit of a Financial Institution”; (3) its capital no longer meets the minimum standards set by the central bank, or its management no longer meets the “fit and proper” requirements of the central bank; (4) it has ceased business for more than six consecutive months or an aggregate period of more than one year; (5) it has been acquired by or has merged with another financial institution; (6) the losses suffered by it during the last three consecutive years account for 10% of its capital or the amount of its losses accounts for 15% or more of its capital; (7) it has failed in an annual inspection and rectification and alteration are unsuccessful, or it has failed in two consecutive annual inspections; (8) it provided false information or did something improper in the course of its application for approval of establishment; or (9) there arise other circumstances determined by the PBOC.¹⁴³

The administrative closure based on the above-mentioned laws or regulations is therefore virtually an administrative tool available to the PBOC to ensure that banks and non-bank financial institutions operate in compliance with the law and regulations.¹⁴⁴ Fortunately, starting from 1997, the PBOC acquired some experience in administrative closure and established a set of standard procedures.¹⁴⁵

(ii) *Closure Procedures*¹⁴⁶

The PBOC takes the following steps to close a problem institution. First, the central bank publishes its decision to close the financial institution and to revoke its business license. At the same time, the closed institution stops operation. In the most recent administrative closure of the Hainan Hong Kong & Macao Trust and Investment Company (HHKMTIC), for example, the PBOC closed the HHKMTIC by revoking its business permit and foreign-currency transaction permit on February 26, 2000.¹⁴⁷

Second, if necessary, the PBOC will designate a financial institution (usually a commercial bank) to take care of the claims against and liabilities of the closed institution,

¹⁴³ In practice, the PBOC will close a financial institution if: (1) it has been continuously loss-making for several years; (2) it is seriously insolvent, cannot meet maturing debts, and has suffered a bank run; or (3) it violates relevant rules or laws. See Zhu, Jun, *supra* note 129, at 306.

¹⁴⁴ *Id.*, at 305; and also Wang, Hailin & Chui, Ligu, ‘Legal Issues Concerning the Closure of Financial Institutions [guanbi jinrong jigou youguan falv wenti de jidian shikao]’, *People’s Daily (Overseas Edition)*, 5 (October 3, 1998).

¹⁴⁵ See Liu, Shiyu, *supra* note 105, at 299-300.

¹⁴⁶ The discussion in this section draws heavily from Zhu, Jun, *supra* note 129 and Xie, Ping, *supra* note 30, at 126-7.

and to wind up its business. In the HHKMTIC case, the BOC was appointed by the PBOC to form a group to settle the HHKMTIC's debts.¹⁴⁸

Third, a liquidation team will be set up to liquidate the assets of the closed institution, to calculate its losses and net assets, and to confirm and register its debt. The team usually comprises representatives from the PBOC and the closed institution, in addition to external experts. With regard to the closure of small institutions owned by local governments, since the repayment of their debts usually involves local budgetary funds, representatives from local governments are sometimes also included in the liquidation team.

Fourth, the liquidation team promulgates principles for the repayment of debts and formulate liquidation plan. The liquidation plan must be submitted to the PBOC for approval. After the liquidation plan is approved by the PBOC, the liquidation term should repay deposit principles and interests and other debts in a timely manner according to the plan.

The administrative closure procedures can be terminated once the liquidator finds that the institution incurred such heavy losses that it is impossible to repay most of its debts. In this circumstance, the institution or its creditors would apply to the court for bankruptcy. Once the bankruptcy procedures begin, the administrative closure procedures terminate. The GITIC is a typical example for that. The GITIC was declared closure by the PBOC on October 6, 1998. In January 1999, the company applied for bankruptcy protection. The application for bankruptcy automatically terminated the administrative closure procedures.¹⁴⁹

(iii) *Advantages and Disadvantages of the Administrative Closure*

The administrative closure has been widely employed by the PBOC to resolve failing financial institutions. So far, the procedures prove to be effective in locking in the level of losses and liabilities, reducing cost in risk management, protecting small and medium depositors, and averting systemic risks.¹⁵⁰

The process of administrative closure, however, takes a significant amount of financial and labor resources on the part of the PBOC and the appointed liquidator (usually a commercial bank). Meanwhile, the resolution of non-performing assets proved to be very

¹⁴⁷ See Kynge, James, 'China Closes ITICs in Hainan', *Fin. Times* (March 1, 2000); and Chinaonline, 'China Shuttters Hainan Hong Kong & Macao Trust' (February 29, 2000), available at '<http://www.chinaonline.com/topstories/000229/2/C00022810.asp>'.

¹⁴⁸ *Supra* note 147.

¹⁴⁹ See Zhu Jun, *supra* note 129, at 313.

¹⁵⁰ See Liu, Shiyu, *supra* note 105, at 301.

difficult. With regard to the administrative closure cases listed in table 4.1, until March 1999, only the liquidation of CATIC had been completed, other closed institutions were still in the liquidation process.¹⁵¹

2. Bankruptcy

(i) *Statutory Provisions*

The Commercial Banking Law provides for the bankruptcy of commercial bank. Article 71 of the Law reads as follows:

When a commercial bank is incapable of repaying its mature debts, may, with the consent of the PBOC, be declared bankrupt by the People's Court. When a commercial bank is declared bankrupt in accordance with the law, the People's Court may organize the PBOC and other relevant departments and personnel to form a liquidation group to conduct liquidation.

At the time of bankruptcy liquidation, a commercial bank shall give priority to paying the principal and interests of savings deposits after paying the liquidation fees and its staff wages and labor insurance fees in arrears.

Apart from this brief article, the only relevant legislation is the 1986 Enterprise Bankruptcy Law,¹⁵² which applies to “enterprises owned by the whole people”;¹⁵³ and Chapter XIX: Procedure for Bankruptcy of Enterprise as Legal Persons of the Civil Procedure Law,¹⁵⁴ which applies to non-state owned enterprise legal persons.¹⁵⁵ These two laws just list briefly in principle the bankruptcy procedures.¹⁵⁶ The sketchiness of the laws creates difficulties in their implementation. The GITIC case demonstrates fully the problem with the legislation.

¹⁵¹ *Id.*, at 300.

¹⁵² Law of the People's Republic of China on Enterprise Bankruptcy (Trial Implementation) [zhonghua renmin gonghegou qiye pochan fa (shixing)], adopted by the 18th Session of the Sixth NPC on December 2, 1986 and effective as of August 1, 1998 (hereinafter referred to as “the Enterprise Bankruptcy Law”).

¹⁵³ *Id.* art. 2.

¹⁵⁴ The Law of Civil Procedure of the People's Republic of China [zhonghua renmin gonghegou minshi susongfa], adopted by the fourth session of the seventh National People's Congress on April 9, 1991 and effective as of the same day.

¹⁵⁵ *Id.* art. 206.

¹⁵⁶ The Enterprise Bankruptcy Law comprises only 43 articles, while Chapter XIX of the Civil Procedure Law contains only 8 articles (arts. 199-206).

(ii) *Problems Raised by the GITIC Case*

The Guangdong International Trust and Investment Company is the first State-owned financial institution to go bankruptcy. GITIC was announced bankruptcy by the Guangdong Provincial High People's Court on January 16, 1999 and is under liquidation now (see Annex XVI).

The GITIC case has raised several interesting legal issues, with the distribution order of bankruptcy estate as the most controversial one. In addition, there are issues related to voidable transactions and the composition of liquidation committee.

Under article 35 of the Enterprise Bankruptcy Law, certain actions carried out during the six-month-period prior to bankruptcy shall be deemed null and void, including private distribution or gratuitous transfer of property, and irregular underselling of property and repayment of immature liabilities.¹⁵⁷ Challenges might be made by creditors under this provision against the transfer to the Guangfa Securities of the GITIC's securities trading business, probably one of the only valuable business operations of the GITIC (see Annex XVI).

Second, the entire composition of the liquidation committee raises questions concerning possible conflicts of interest and the fairness of the liquidation process. In addition to a representative of Guangfa Securities, another member of the liquidation committee is a representative of the BOC, one of GITIC's largest creditors. Furthermore, the liquidation committee also includes officials from the Guangdong provincial government, which is technically the owner of the GITIC, as well as members of the former management of GITIC. All of them arguably have conflicts of interest.¹⁵⁸ This, together with the dominant role that is played by the liquidation committee,¹⁵⁹ makes potential conflicts very likely to occur between the liquidation committee and the creditors' committee.¹⁶⁰ This problem is a

¹⁵⁷ The Enterprise Bankruptcy Law, *supra* note 152, art. 35.

¹⁵⁸ See, e.g., Chang, TK, 'The Easter Is in the Red', *International Financial Law Review*, 43, at 45 (March, 1999).

¹⁵⁹ The liquidation committee has broad powers under the Enterprise Bankruptcy Law respecting the valuation, disposition, and distribution of the debtor's property. The Enterprise Bankruptcy Law, *supra* note 152, art. 24.

¹⁶⁰ In most circumstances, the conflict would not result in damaging creditors' rights. Under the Enterprise Bankruptcy Law, the creditors' committee is authorized: (1) to examine evidence concerning claims, to determine whether the claims are secured or unsecured and their respective amounts; (2) to discuss and approve the draft conciliation agreement; and (3) to discuss and approve the plan by which the debtor's assets are to be administrated and distributed. *Id.* art. 15. The Law further provides that a plan for distribution "will be implemented following its discussion and adoption at a creditors' meeting and further submitted to the people's court for a ruling." *Id.* art. 37.

result of the briefness of China's Enterprise Bankruptcy Law, which provides that the people's court shall designate members for liquidation committee from among the government departments in direct charge of the debtor enterprise, government finance departments, and other relevant departments and professional personnel.¹⁶¹

C. MERGER AND TAKE OVER (PURCHASE & ASSUMPTION)

1. General Introduction

Mergers are usually based on commercial principles. In such circumstances, the merger is an autonomous decision made by financial institutions. However, mergers can be used as restructuring instruments by banking supervisors. Banking supervisors may compel problem institutions to merge with each other or merge with a healthy and sound institution.¹⁶² Compared to a straight liquidation, a merger or take over generally minimizes disruption in the economy by avoiding interruption of banking operations and allowing credit relationships to be maintained.¹⁶³

Purchase and Assumption is a variation of merger. In a P & A operation, a solvent bank purchases a portion of the assets of a failing bank, including its customer base and goodwill, and assumes all or part of its liabilities. In a publicly supported P & A operation, the government will usually make up the shortfall in the value of the assets and the liabilities. Variations of P & A operations could be a purchase of assets, entitling the acquiring bank to return certain assets within a specified time period, or a contractual profit/loss-sharing

There are possibilities, however, that a plan for distribution will be implemented even without the approval of the creditors' meeting, because the people's court, on its own, may approve a plan that has been submitted by the liquidation group to the creditors and still has not been passed "after being discussed several times." Opinions of the Supreme People's Court on Issues Concerning the Implementation of the Law of Bankruptcy for Enterprises of the People's Republic of China (November 7, 1991), art. 31.

¹⁶¹ The Enterprise Bankruptcy Law, *supra* note 152, art. 24, paragraph 2.

¹⁶² See Zhu Jun, *supra* note 129, at 308.

¹⁶³ The only immediate effect of merger or take over on insured depositors is that the name of their bank has changed. In principle uninsured creditors may lose their money in the transaction, but most often in practice in the US and a number of other countries all depositor's claims are assumed. See Dewatripont, Mathias & Tirole, Jean, *supra* note 58, at 68.

agreement¹⁶⁴ related to some or all the assets. P & A in the context of bank resolution can include that bad assets are liquidated or transferred to an AMC.¹⁶⁵

2. The Chinese Practice

Mergers have been widely applied by Chinese authorities to mitigate financial risks resulting from ailing financial institutions. From 1995 to 1998, for example, more than 2,000 urban credit cooperatives were merged into 88 city commercial banks.¹⁶⁶

P & A has also been used in China to deal with failing financial institutions. In March 1999, China Everbright Bank acquired the commercial banking assets of China's Investment Bank¹⁶⁷ (see Annex XVII).

D. RESCUE PACKAGE OR OPEN BANK ASSISTANCE

1. General Introduction

Open bank assistance is a way to preserve the ailing entity by restoring its solvency and viability. The main feature of this option is that the failing institution is neither closed nor taken over by other institutions but is rescued on an "open bank" basis through the infusion of new funds. Rescue packages can take various forms, including soft loans or deposits from the government, asset (usually non-performing assets) or securities purchase, and assumption of liabilities or capital injection.¹⁶⁸

Open bank assistance can be combined with private participation. The government, for example, may place a call on existing shareholders to recapitalize the institution or arrange a debt-equity swap with existing creditors. These methods, however, cannot be

¹⁶⁴ E.g., in the US, when the supply of failed bank assets expanded to unprecedented levels in the early 1990s, in order to stimulate bidding during the resolution process, the FDIC modified the P & A transaction to include a loss-sharing feature whereby the government agreed to cover a certain portion of potential losses on assets purchased by the acquirer. See, e.g., Ketcha, Nicholas J Jr., *supra* note 3, at 236-7.

¹⁶⁵ See Balino, Tomas J. T., Enoch Charles *et al.*, *supra* note 14, at 23 & box 3.

¹⁶⁶ See Xie, Ping, *supra* note 30, at 125.

¹⁶⁷ See, e.g., Macmahon, William J., 'Everbright and CIB Merge in a Strong Bank-Weak Bank Rescue', available at 'http://www.chinaonline.com/top_stories/breakingnews_b9031915.html'; Kynge, James, 'China: Everbright Acquires State Bank', *Fin. Times* (March 19, 1999); Wang, Xiaowei, 'Huge Credit Risks Seen in CIB Acquisition Everbright Takes Over Bad Loans', *South China Morning Post* (March 19, 1999); and Wang, Xiaowei, 'Everbright to Double Assets CIB Branches Changing Hands', *South China Morning Post* (March 18, 1999).

¹⁶⁸ See Macey, J. & Miller, G., *Banking Law and Regulation*, 643 (1992).

applied to a bank whose capital has eroded severely because of an extended period of inaction by regulators. Such circumstances often lead to the nationalization of the bank.¹⁶⁹

In many cases, the management of the institution is revamped in a program of open bank assistance. The government can impose other conditions on the provision of assistance. In other words, there are chances for the government to force a restructuring of a ailing institution in open bank assistance. The use of open bank assistance, however, creates concerns involving fairness, cost, and moral hazard.¹⁷⁰ Reflecting these concerns, recent legislation in the US has restricted the FDIC's ability to recapitalize troubled institutions. The FDIC is required to show that open bank assistance is the resolution alternative least costly to the insurance funds. In addition, insurance fund moneys cannot be used to benefit shareholders of failing institution.¹⁷¹

2. Application in China

Like authorities in other countries, the Chinese government has applied open bank assistance, mainly in the form of liquidity support, to deal with problem institutions. The PBOC as the LOLR has provided liquidity to financial institutions coming across liquidity problem.

Government injection of capital has also been applied. In 1998, the MOF recapitalized the "big four". There has been open bank assistance conducted by local government as well — when small-sized institutions owned by local governments meet with difficulties, it is usually the local governments that take responsibilities for assisting or rescuing them through new capital injection or liquidity support.¹⁷²

One recent case of open bank assistance is the rescue of the Weihai City Commercial Bank (hereinafter referred to as the Weihai Bank).¹⁷³ The Weihai Bank was established via the merger of five urban credit cooperatives. Due to problems inherited from the former credit cooperatives, mismanagement, and deteriorating creditworthiness, the bank occurred serious liquidity problem and could not meet its obligations. In September 1997, the PBOC provided some loans to alleviate the bank's liquidity pressure and approved the bank's application to increase paid-in capital to RMB350m and a nominal capital adequacy to 9.09%

¹⁶⁹ See Balino, Tomas J. T., Enoch Charles *et al.*, *supra* note 14, at 23 & box 3.

¹⁷⁰ See, e.g., Lastra, Rosa Maria, *supra* note 4, at 136-7.

¹⁷¹ See, e.g., Ketcha, Nicholas J Jr., *supra* note 3, at 238.

¹⁷² It was reported, however, that local governments were unwilling to inject fresh funds unless they were under great pressure. See Xie, Ping, *supra* note 30 at 125.

by raising RMB250m new capital. All these strengthened the bank's capacity to shield against risks. As a result, the bank's operation was gradually put back on track.

The debt-equity swap technique has also been used to rescue weak financial institutions.¹⁷⁴ In October 1996, the Everbright Trust and Investment Company, whose largest creditors included a State oil firm and two State-owned commercial banks, could not meet its mature debts. To avoid its bankruptcy, the central bank decided to convert its debts, of about RMB5bn, into equity.

E. MANAGEMENT TAKEOVER (A VARIATION OF BRIDGE BANK)

1. The Bridge Bank Practice

Sometimes an existing bank will be designated by the government to take care assets of ailing institutions; or, the government may choose to charter a new bank to do that. This is referred to as the bridge bank practice.¹⁷⁵ A bridge bank is often a temporary solution in order to take over the operations of a failed bank and preserve its going-concern value while the government is seeking a more permanent solution to the problem or until an acquirer is found.¹⁷⁶

The bridge bank is particularly suitable for dealing with the failure of large bank with complex financial structure, because it affords the resolution authority sufficient time to evaluate and market the institutions. A disadvantage of using a bridge bank is that it entails greater government involvement in banking operations than other resolution methods.¹⁷⁷

A central bank itself can be the bridge bank as well. For example, after the collapse of Baring in 1995, the bank was first placed in administration by the Bank of England before it was sold to ING, the Dutch banking and insurance group.¹⁷⁸ In the US, since 1987 the FDIC can own and operate a bank until a more permanent solution can be arranged.¹⁷⁹

2. Management Takeover in China

¹⁷³ For details of this case, see Liu, Shiyu, *supra* note 105, at 301-2.

¹⁷⁴ The discussion in this paragraph based solely on Xie, Ping, *supra* note 30, at 125.

¹⁷⁵ See Balino, Tomas J. T., Enoch Charles, *et al.*, *supra* note 14, at 23 & box 3.

¹⁷⁶ See, e.g., Lastra, Rosa Maria, *supra* note 4, at 138.

¹⁷⁷ See, e.g., Ketcha, Nicholas J Jr., *supra* note 3, at 237.

¹⁷⁸ See, e.g., Lastra, Rosa Maria, *supra* note 4, at 138.

Management take-over is the Chinese variation of the bridge bank practice.¹⁸⁰ The Management take-over is provided by the Commercial Banking Law as a solution to restore the health of failing commercial banks. Article 64 of the law provides that when “a commercial bank is in or is likely to be in a credit crisis thus seriously threatening the interests of the depositors, the People’s Bank of China may take-over the said bank,” with the purpose of protecting the interests of the depositors and helping the commercial bank resume its normal operations.¹⁸¹ One obvious advantage of the management take-over is that it will not disturb the existing bank-firm relationships: During the period of management take-over, the “debtor-creditor relationship of the commercial bank existing before the take-over remains unchanged.”¹⁸²

The Commercial Banking Law provides procedures for management take-over. Accordingly, a management take-over should be determined by the PBOC and carried out under the organization of the PBOC.¹⁸³ The PBOC should make public its take-over decision and specify the following contents in its take-over decision: (1) the name of the commercial bank to be taken over; (2) the reason(s) for the take over; (3) the entity taking over; and (4) the time limit of the take-over.¹⁸⁴

A management take-over begins on the day of implementation of the take-over decision. The entity authorized by the PBOC to carry out the management take-over should begin exercising the power over the management of the commercial bank from the day of implementing the take-over decision.¹⁸⁵ On expiration of the term of the take-over, the PBOC may determine to prolong the take-over, but the term should not exceed two years to the maximum.¹⁸⁶

A management take-over must be terminated in any of the following circumstances: (1) that the term of the take-over expires or the prolonged term of take-over determined by the PBOC expires; (2) that prior to the expiration of the term of take-over, the commercial bank has recovered its capacity of normal operation; or (3) that prior to the expiration of the

¹⁷⁹ The FDIC operation of a bank is limited to two years (with a possible third-year extension). See Dewatripont, Mathias & Tirole, Jean, *supra* note 58, at 69.

¹⁸⁰ See Liu, Shiyu, *supra* note 105, at 302. Management takeover has been applied as a resolution of problem urban credit cooperatives in Guiyang City, Guizhou Province. *Id.*

¹⁸¹ The Commercial Banking Law, *supra* note 73, art. 64.

¹⁸² *Id.*

¹⁸³ *Id.*, art. 65.

¹⁸⁴ *Id.*

¹⁸⁵ *Id.*, art. 66.

term of takeover, the commercial bank has been merged or declared bankrupt in accordance with the law.¹⁸⁷

F. PROBLEMS WITH CHINA'S BANK INSOLVENCY RESOLUTION

As discussed above, China has applied most alternatives to resolve the problem of failing financial institutions. Most of the financial institutions so far tackled, however, are medium- and small-sized non-bank financial institutions. Only two commercial banks went through the resolution procedures: the Hainan Development Bank and China Investment Bank. Although the system has not been fully tested, problems have already arisen in the course of these limited practices.

1. The Uncertainty in Treating Foreign Creditors

The treatment of foreign creditors of closed financial institutions has experienced certain variability. This creates uncertainty and unpredictability for both foreign and domestic creditors.

When the Hainan Development Bank was closed on June 21, 1998. The PBOC stated that the ICBC would guarantee repayment of all external debts and all the principal and interest on deposits lawfully held by the PRC individuals.¹⁸⁸ That was the case for the closure of China Venturetech as well.¹⁸⁹

The policy changed slightly, however, when the PBOC declared the closure of GITIC. In its notice to close the GITIC, the PBOC stated that "overseas liabilities registered with the foreign exchange administration authorities and the legal principal and interests of deposits of domestic natural persons shall have priority for repayment."¹⁹⁰ There are at least two major differences between this Notice and the previously cited ones. First, it was not mentioned in the earlier notices that the external debts had to be those that had been duly registered with the SAFE. Second, the repayment of external debts owed by the Hainan

¹⁸⁶ *Id.*, art. 67.

¹⁸⁷ *Id.*, art. 68.

¹⁸⁸ See, e.g., Lam, Joseph, 'The Closure of GITIC', *J.I.B.L.* No. 4, 127, at 127 (1999).

¹⁸⁹ In the closure of China Venturetech, the PBOC published a public announcement dated June 22 1998 in the national press, which stated unequivocally: "The overseas liabilities and the legal liabilities to domestic natural persons of the original China Venturetech Investment Corporation shall be repaid in full." See Chang, TK, *supra* note 158, at 45.

Development Bank and China Venturetech was guaranteed, whereas external debts owed by GITIC that had been registered with the SAFE would only be paid in priority along with household deposit and savings.¹⁹¹ The GITIC Notice, however, still granted preferential treatment to foreign creditors.¹⁹²

The GITIC bankruptcy marked the abolishment of preferential treatments to foreign creditors. At the January 10, 1999 meeting held by the Liquidation Group announcing the resolution of the GITIC board of directors to petition for bankruptcy, Mr. Wu, Jiesi, the head of the Liquidation Group, indicated that all creditors, whether domestic or foreign, would be treated equally in accordance with the PRC company law and the bankruptcy law. Contrary to the PBOC Notice, overseas creditors would not get any priority in repayment even if their debts had been duly registered with the SAFE.

The rule for pure administrative closure seems to have changed as well. In the most recent administrative closure of the Hainan Hong Kong & Macao Trust,¹⁹³ it was revealed that payment to foreign creditors was no longer a priority, while compensation for individual depositors would still be given top priority.¹⁹⁴

Such changes are obviously in the right direction.¹⁹⁵ The author's concern here is that without clear rules, there is uncertainty for both overseas and local creditors. It is therefore important to establish clearly rules that foreign and domestic creditors will be treated equally.

2. The PBOC's Autonomy in Dealing with Problem Institutions

Ensuring the central bank's independence of action is a long-standing issue. In China, except the "big four", most of the financial institutions are either solely owned by local governments or largely controlled by them. Local governments usually appoint senior management of

¹⁹⁰ *Id.*, at 44.

¹⁹¹ See Lam, Joseph, *supra* note 188, at 127.

¹⁹² The main consideration of the Chinese authorities was to protect the interest of foreign institutions and foreign investors, to maintain the creditworthiness of Chinese financial institutions, and most importantly, to keep the confidence of foreign investors in the sound development of the Chinese economy. The preferential treatment to foreign creditors, however, has been ruining the incentives for foreign lenders to monitor the creditworthiness of Chinese borrowers, resulting in their reckless lending to State-owned financial institutions in China. See Zhu, Jun, *supra* note 129, at 315.

¹⁹³ *Supra* note 147.

¹⁹⁴ See Kynge, James, *supra* note 147.

¹⁹⁵ It was suggested that with the establishment of a diversified financial system and strengthened financial supervision, the preferential treatments towards overseas creditors should be removed gradually to create competitive equality. See Zhu, Jun, *supra* note 129, at 315.

financial institutions and intervene heavily in their business.¹⁹⁶ While local governments assume limited responsibility for providing funds for the merger, restructuring, closure, and even bankruptcy of financial institutions, they often intervene in all the insolvency resolution on behalf of their interests.¹⁹⁷ This has greatly impeded the central bank from making decisions completely according to market discipline.¹⁹⁸

Actually, even if the PBOC had full autonomy in deciding how to deal with problem institutions, there remains the problem whether the PBOC will make decisions completely following the market discipline. The PBOC, because it is simultaneously financial regulator and monetary policy agency, has to take into consideration the impact of financial institution liquidation on the entire financial system and the whole economy, and sometimes may prefer to apply other insolvency resolution approaches rather than closure and liquidation.

3. Inadequate Transparency and Disclosure

Inadequate transparency and disclosure has materialized in two aspects. In the disclosure aspect, although certain disclosure requirements for financial institutions have been established, few institutions publish their fundamental indicators regularly, and the reliability and accuracy of the information disclosed by these institutions remains doubtful, as clearly evidenced in the GITIC case.

Creditors of GITIC had two blows with regard to the financial condition of the company. The first shock came at the creditors' meeting on January 10, 1999, immediately prior to the declaration of GITIC's bankruptcy when the creditors were given the preliminary results of the verification of the assets and liabilities of GITIC. It was revealed that the GITIC had assets of only RMB21.471bn, compared to the RMB35.878bn prior to the verification. Furthermore, prior to the verification, the GITIC was thought to have 66 domestic subsidiaries and 66 overseas subsidiaries, whereas after verification, the GITIC was discovered to have as many as 105 domestic subsidiaries and 135 overseas subsidiaries.¹⁹⁹ The second shock was given in April 1999 at the first creditors' meeting after the initiation of

¹⁹⁶ See Xie, Ping, *supra* note 30, at 128.

¹⁹⁷ *Id.*

¹⁹⁸ See Zhu, Jun, *supra* note 129, at 317.

¹⁹⁹ See Chang, TK, *supra* note 158.

the bankruptcy procedure. It was revealed that the GITIC had recoverable assets of only RMB6.5bn (\$785m), much lower than the RMB21.471bn announced in January.²⁰⁰

These discrepancies raise disquieting questions about the overall reliability of the financial statements of GITIC, which had been audited by international accounting firms, as well as the accuracy and adequacy of the disclosure in the offering memoranda, prospectuses and placement documents used in raising the over \$4bn in indebtedness for GITIC.²⁰¹

As for the transparency aspect, the opaqueness of the financial institution insolvency resolution is widely criticized, especially the opaqueness of the administrative closure procedure. The most obvious problem is the treatment of foreign creditors. As mentioned before, foreign creditors were given priority in all the administrative closures prior to the GITIC case, afterwards, however, only household depositors are given priority. The real problem here is not whether priority should be granted to foreign debts (although this has been widely criticized by domestic creditors²⁰²), but that this lack of uniform rules has made administrative closure procedures opaque and inconsistent.

G. BUILDING UP A SOLID LEGAL INFRASTRUCTURE FOR BANK INSOLVENCY RESOLUTION

1. General Consideration: Should China Adopt Special Legislation on Bank Insolvency Resolution

In most countries, bank failures are not subject to general corporate bankruptcy procedures, but to special insolvency proceedings — “Though a bank becomes economically insolvent when the market value of its net worth reaches zero, an economically insolvent bank need not be declared legally insolvent by the responsible agency and may be offered instead financial

²⁰⁰ See, e.g., Miller, Matthew, ‘Questions of Felony Emerge in Gitic Crash’, *South China Morning Post* 3 (April 23, 1999). The estimation was raised to RMB7.69bn on October 22, 1999 at the second creditors’ meeting. See Lin, Ho Swee, ‘GITIC: Payout Blow for Creditors’, *Fin. Times* (October 23, 1999).

²⁰¹ See Chang, TK, *supra* note 158.

²⁰² The domestic creditors, for example, protested the unfairness of such priority in the liquidations of China Venturetech and other cases. *Id.*, at 45.

assistance.”²⁰³ The EU Convention on Insolvency Proceedings,²⁰⁴ for example, excludes banks and other financial institutions from its scope.²⁰⁵

Several reasons can be attributed to this differentiation. First, banks are the repository of the savings of the public and the principal source of credit to the economy. Therefore the law should be especially concerned with the fair and efficient resolution of bank insolvencies to limit the losses of savings and the decrease in sources of credit.²⁰⁶ Second, banks are vulnerable to bank runs, a bankruptcy suit brought by creditors, even if proves unjustified, may terminally damage confidence in a bank. Hence there is a consensus that the initiation of insolvency proceedings against a bank should be left only to the supervisor or other government agencies.²⁰⁷

China has every reason to differentiate bank insolvency from normal enterprise insolvency, given the problems with its Enterprise Bankruptcy Law, its under-developed financial markets, and the importance of banks in its financial system and the whole economic system. The question becomes whether China should have a special law on bank insolvency, or make special rules for bank insolvency in its Commercial Banking Law.

This author would recommend that China make special rules for bank insolvency in its Commercial Banking Law, instead of having a special law on bank insolvency, based on three considerations. First, bank failures do not happen frequently, it is not economic to spend time and other resources in drafting a separate law for bank insolvency. Second, the provisions of law that may govern bank insolvency can be exceedingly complex. It will be extremely difficult for the Chinese legislator to develop a practicable special legislation on bank insolvency. Third, China already adopts the model to include the provisions on bank insolvency in its Commercial Banking Law.

2. Issues that Need to Be Clarified for Bank Insolvency Resolution in China

²⁰³ See, e.g., Lastra, Rosa Maria, *supra* note 4, at 134-5.

²⁰⁴ Convention on Insolvency Proceedings (CONV/INSOL/X1). This is a document of the EU Council and is not effective yet. The Convention was signed by 14 Member States (but not the UK) in November 1995.

²⁰⁵ The EU drafted a proposed directive in the mid 1980s concerning the “winding-up and reorganization measures” for credit institutions. Although it never reached the stage of a common position in the European Council by Ministers, it is an important piece of draft legislation that is still on the table of the EU Council. See generally Clarotti, Paolo, ‘Legislation Related to Bank Insolvency in the European Union’ in Lastra, R. M., Schiffman, Henry N. (eds.), *Bank Failures and Bank Insolvency Law in Economies in Transition*, 311 (1999).

²⁰⁶ See, e.g., Schiffman, Henry N., ‘Legal Measures to Manage Bank Insolvency in Economies in Transition’ in Lastra, R. M., Schiffman, Henry N. (eds.), *Bank Failures and Bank Insolvency Law in Economies in Transition*, 81, at 82 (1999).

(i) *The Autonomy of the PBOC in Deciding Insolvency Resolution and Its Limitation*

It has been an established rule that banking supervisors should have discretion in taking PCAs (including the closure of insolvent financial institutions).²⁰⁸ The 1998 institutional restructuring of the PBOC, which consolidated its branches into nine and aimed at reducing intervention from local governments, is an important step forward to a more independent central bank. The autonomy of the PBOC in deciding insolvency resolution of financial institutions, however, remains to be strengthened. It should be clarified that the PBOC has the power to make decision independently about how a problem financial institution should be dealt with, no matter it is owned privately or publicly, and no matter it is owned by the central government or local governments.

It is also necessary, however, to impose some limitations on the PBOC's discretion in making insolvency resolution decisions. As indicated above, the dual roles of the PBOC as the monetary policy agency and bank regulator may result in the PBOC's bias against liquidation as an insolvency resolution approach.

With regard to this issue, the author would like to suggest that China should at least adopt the cost-test criteria applied in the US, where the FDIC is mandated to minimize the "expected cost" of failure resolution. In particular, the FDIC is required to run a statutory cost test showing that the alternative measures are not more costly than liquidation.²⁰⁹ Although the broad requirements prove not very effective,²¹⁰ it would be better than having no limitation.

(ii) *Elaborating Provisions on Administrative Closure*

The administrative closure is one of the most controversial insolvency resolution procedures, partly because it is most extensively used in China. The legal basis for administrative closure is extremely thin in China. As mentioned above, the current legal basis for administrative closure is articles in the Commercial Banking Law and 1994 PBOC Provisions on Financial

²⁰⁷ See Hawkins, John & Turner Philip, *supra* note 29, at 36.

²⁰⁸ See, e.g., Schiffman, Henry N., *supra* note 206, at 95-8.

²⁰⁹ See, e.g., Dewatripont, Mathias & Tirole, Jean, *supra* note 58, at 70-71.

²¹⁰ The carrying out of this principle involves a fair amount of judgment. On the one hand, it is hard to forecast the costs of liquidation or a merger. On the other hand, the cost does not need to be limited to the FDIC's monetary outlay but can include the cost of some externalities, such as the disruption of the local economy and

Institution Administration. These articles only list out the preconditions for administrative closure. Although the PBOC has worked out a procedure itself via practice, there are inconsistencies within the PBOC practices.

In the current author's view, at least the following points should be made clear for the implementation of administrative closure in China: (1) that the administrative closure is not merely a punishment for illegalities or irregularities, but a PCA that the PBOC can take to deal with problem financial institutions; and (2) liquidation rules, especially the distribution order of the assets of the administratively closed financial institution.

(iii) *Rules on Bank Bankruptcy Must Be Established in More Details*

The insufficiency of the Enterprise Bankruptcy law in dealing with the bankruptcy of financial institution has been fully evidenced by the GITIC case. The Commercial Banking Law only contains one article on bank bankruptcy.²¹¹ That is obviously not enough to tackle the complexity of bank bankruptcy. Hopefully, the GITIC case should be able to give the Chinese legislator some hints to formulate rules for bank bankruptcy.

V. CONCLUSION

A banking safety net is essential to ensure that failures of individual bank will not affect the soundness and stability of the entire banking system. A well-designed banking safety net can also guarantee that depositors are properly protected when market discipline is imposed on unsound individual institutions. A banking safety net usually consists of various components such as LOLR, deposit insurance, and bank insolvency resolution.

The importance of having a LOLR is seldom contested. The theoretical foundations for LOLR were set more than two centuries ago. To define LOLR in practice, however, is not an easy job. The difficulties in defining LOLR in practice call for an appropriate definition of LOLR either by legislation or by central bank practices.

In China, the conditions and procedures to provide LOLR are not clearly defined, which leaves the PBOC vulnerable to political pressures from central and local governments. After comparing the US, UK and Japan models of defining LOLR facilities, the author

the systemic risks. For these reasons, authorities have usually preferred to bail out unsecured depositors and have refrained from liquidating large banks. *Id.*

²¹¹ The Commercial Banking Law, *supra* note 73, art. 71.

suggests that China should follow the Japan model to define the PBOC's LOLR role in the Central Banking Law, clarifying that the PBOC should only extend credit to those temporary illiquid but not insolvent financial institutions when there is a threat to the soundness and stability of the financial system and the extension of the credit is necessary to avoid a serious disturbance in the economy; and that credit advances should be limited in maturity and extendibility and require satisfactory collateral. Procedures for decision-making should be prescribed as well, including the authority of the person or persons to make the decision (the PBOC Governor, or the PBOC Monetary Policy Commission) and consultative requirements (the PBOC should consult with the MOF before it decides to extend emergency credit).

Despite theoretical arguments in favor of or against establishing deposit insurance programs, deposit insurance has been developed in almost all developed countries and most of the developing countries. The doctrine of necessity offers a good explanation to the adoption of deposit insurance system by most countries.

The doctrine of necessity exists in China as well. China has long been carrying an implicit government guarantee. It is time now for China to replace its current implicit government guarantee with an explicit and limited deposit insurance program. A Deposit Insurance Company should be established by legislation to provide deposit insurance to deposits in all deposit taking institutions in China (including the "big four"). The Company would collect premiums from depositary institutions (at flat rate), manage the deposit insurance fund, and would pay off depositors when an insured institution is closed. The Company would be affiliated to the PBOC, with the authority to inspect and examine the deposit-taking institutions and to deal with problem institutions. Respecting the coverage of deposit insurance, it is recommended that the deposit insurance only protect the individual depositors, with floor and ceiling set for compensation to a single individual depositor.

Effective and timely resolution of insolvencies is probably one of the most important elements for a banking safety net. The timely resolution of failed institutions would reinforce systemic stability, promote public confidence in the system, and would restore liquidity to the economy. Basic regulatory options to deal with a failed bank include closure and liquidation (deposit payoff), rescue package or open bank assistance, merger and take over (*e.g.*, purchase and assumption), and bridge bank.

All these mechanisms have been applied in some form in China, although China's Commercial Banking Law only provides about the management take-over (a variation of

bridge bank) and liquidation (including bankruptcy) of commercial banks. To date, most of the financial institutions tackled are medium and small non-bank financial institutions.

There are problems with China's current insolvency resolution practices, such as the unfair treatment of creditors, the local governments' intervention in the PBOC's decision-making in insolvency resolution, and inadequate transparency and disclosure.

China needs a solid legal infrastructure for bank insolvency resolution. As a developing country, China has every reason to differentiate bank insolvency from enterprise insolvency. That does not mean, however, that China should adopt a special legislation on bank insolvency resolution. But clearer rules concerning bank insolvency resolution need to be established in China's Commercial Banking Law.

I. INTRODUCTION

Following the analyses on the causes of China's State commercial bank NPL problem, a number of recommendations can be made for bank NPL workouts and prevention on the premise that without restoring market discipline in China, especially market discipline on State commercial banks and SOEs, the NPL problem in China cannot be really resolved.

Apart from the important premise raised above, this concluding chapter comprises six more sections. Section II concludes the analyses of Chapter One and points out that the failure of market discipline lies at the root of the State commercial bank NPL problem. In Section III, it is recommended that a comprehensive bank restructuring comprising bank recapitalization, NPL management, enhancement of banking regulation and supervision, and promotion of bank internal controls should be adopted by the Chinese Government to workout the existing NPLs and to prevent the creation of new NPLs. Discussions in Chapter Two are summarized in Section IV, focusing on the impact of the AMC practices on the restoration of market discipline in China. The legal framework for NPL management in China is discussed in this Section as well. Section V abridges the discussion in Chapter Three and concludes that a partnership relationship between banking regulation and market discipline should be developed in China. Section VI outlines the discussion in Chapter Four and concludes that an appropriate banking safety net needs to be established to enhance market discipline and prudential regulation in China. The Chapter ends with some concluding remarks in Section VII.

II. THE FAILURE OF MARKET DISCIPLINE — THE ULTIMATE ROOT OF THE STATE COMMERCIAL BANK NPL PROBLEM

Most of the NPLs result from unsustainable borrowing, *i.e.*, borrowing without the means or even the intention of repaying. Market discipline is one force that might limit such abuse of financial market: Market discipline implies that lenders penalize excessive borrowing, first, by requiring a higher interest rate spread and, ultimately, by excluding the borrower from the market. Moreover, the lender's discipline function can be expanded to the moment after the funds have been lent in two instances — The lender monitors the borrower to ensure that the use of funds is consistent with the loan contract; and more importantly, the lender forces the defaulted borrower either to restructure in order to survive or to exit. If market discipline could work effectively, credit will be hardened and hence unsustainable borrowing can be efficiently curbed.

There are conditions for market discipline to work effectively. These conditions include the competitiveness of capital markets, the availability of information on the borrower's outstanding liabilities, no expectation for bailout, and the borrower's capability and willingness to respond to market signals provided by interest rate spreads. All these conditions fail in China.

A. THE CAPTIVE FINANCIAL MARKETS

The financial markets in China are extremely captive. In a State bank-dominated/bank-centric financial system, households and enterprises do not have many choices but to deposit or save their extra money with State banks.

Banks are facing a captive market as well. Massive administrative controls on banks actually have deprived banks of the freedom to make lending decisions on commercial standards. Before the division of business scope among State specialized banks was abolished, the “big four” could only lend to enterprises in certain areas or industrial sectors. State banks had very limited freedom in deciding to whom to lend under the credit plan. Although the credit ceiling was removed in 1998, State commercial banks are still forced to lend to un-bankable projects and loss-making SOEs.

B. THE INFORMATION PROBLEM

The information problem is not exclusive to socialist economies. This problem, however, bears unique features in socialist economies: In capitalist economies, the information is utilized in a decentralized way. Those using the information feel the benefits of it directly. In pre-reform socialist economies, attempts were made to centralize crumbs of knowledge and information that were scattered in all directions. And, if the information in the subordinate's possession had to be "passed up the ladder", it might not be in his interest to transmit it; or, it might be fully in his interest to pass it up in a distorted form. This explains why the information problem is more serious in formerly planned economies.¹

The lack of incentive to use information survives the economic reform in China. SOEs, knowing that banks will eventually lend to them, have no incentive to produce favorable information about their financial situation, let alone unfavorable information. Banks, aware that they have to lend to certain enterprises or projects, do not have incentives to evaluate borrowers' creditworthiness and monitor borrowers' cash flow. Besides, the inappropriate prudential regulation is not enough of an external check that banks examine their borrowers' creditworthiness properly.

The veracity of the information also poses a serious problem. The underdeveloped accounting rules and disclosure practices have impeded banks from obtaining reliable information about their borrowers.² Actually, even if they obtained the relevant information, their immature internal controls and risk-management ability are still obstacles for them to evaluate the borrower's financial situation properly.

C. THE BAILOUT EXPECTATION

The implicit and explicit government guarantees have made banks and SOEs resort to government bailout whenever they encounter difficulties. The economic reform has substantially reduced budget subsidies, soft tax, and price subsidies on SOEs; the soft budget

¹ See Kornai, Janos, *The Socialist System: The Political Economy of Communism*, 129-30 (1992).

² A random state audit of 100 SOEs in China found that 81 of the companies reported false assets worth RMB3.8bn, and that 89 SOEs reported false profits worth RMB2.7bn in 1999. To be worse, previous audits of the 100 SOEs by 82 public auditing firms found nothing awry with the accounts of 62 of the firms, which seriously undermines confidence in public auditors. See Chinaonline, 'Random Audit Exposes Accounting Fraud in Most Chinese SOEs' (December 27, 1999), available at 'http://www.chinaonline.com/issues/econ_news/currentnews/secure/C9122305.asp'.

constraints, however, are far from ceasing its existence. Rather, they now mainly exist in the form of soft credit from banks.

D. THE IRRESPONSIBILITY TO MARKET SIGNALS BY BORROWERS

Borrowers' ignorance of market signals can be explained by the soft budget constraints. The soft budget constraints make the firm's interest in cost and profit very weak and pale. Actually, even if borrowers have the incentive to respond to interest rate signals, the interest rates in China are not signaling properly — banks are not allowed to adjust the interest rates freely.

III. SYSTEMATIC BANKING AND SOE RESTRUCTURING — STRATEGIES TOWARD THE BANK NPL PROBLEM IN CHINA

A. THE NECESSITY OF A COMPREHENSIVE BANK AND SOE RESTRUCTURING

China's bank NPL problem is actually a reflection of the weakness in its financial and corporate sector and needs a systematic solution. The solution needs to be comprehensive and credible and should repair the weak and insolvent banks and corporations simultaneously.

Theoretically, there are three strategies to deal with systemic banking problem: closure and liquidation in large scale, regulatory forbearance, and a systematic bank restructuring. Closure and liquidation in large size is not suitable for China simply because China cannot afford to close and to liquidate the "big four". Regulatory forbearance has been applied by authorities in China and proved a failure, because the prerequisites for the successfully application of regulatory forbearance do not exist in China.

The necessity of a comprehensive bank and SOE restructuring can be argued for on the experience of Asian crisis countries, on the risk of low-level equilibrium in economics³ and on the seriousness and causes of the bank NPL problem in China. Moreover, it can be argued for on the basis of restoring market discipline on China's State commercial banks and SOEs.

³ See relevant discussion in Chapter One.

The Chinese Government has been trying to harden budget constraints on SOEs even since the very beginning of the economic reform. The efforts of the Government are progressing slowly, however. In his opening speech of the annual session of the NPC in 1999, Zhu Rongji admitted that “financial discipline is [still] lax and economic order is somewhat in disarray.”⁴ Without solving the NPL problem, insolvent State commercial banks with large exposure to SOEs will have to continue to lend to loss-making SOEs, if they do not want to be pulled down by the collapse of their large borrowers (adverse selection). In other words, it is impossible to expect State commercial banks trapped in NPLs to exercise financial discipline on SOEs if NPLs cannot be removed from their balance sheets.

B. KEY STEPS FOR BANK AND SOE RESTRUCTURING IN CHINA

The IMF has summarized ten critical steps in three phases in managing and resolving a systemic bank crisis and has concluded that although specific actions may differ among countries based on the depth of the crisis, the composition of the financial sector before the crisis, and local circumstances and preferences, the contents and sequence of the basic building blocks and strategies should be similar across countries.

So far, China has succeeded in immunizing itself from the contagions of the financial crisis and has not experienced the acute crisis phase. And because of the comparative stability of China’s financial system, there is no urgent need for the Chinese Government to apply immediate stabilizing methods. Several key steps aiming at the existing NPLs workouts and the prevention of the creation of new NPLs, however, are being taken or should be taken by the Chinese government. These include bank recapitalization, NPL management, enhancement of banking regulation and supervision, and promotion of bank internal controls (especially risk-management capacity).

IV. RESOLVING THE STOCK OF NPL: BANK RECAPITALIZATION AND NPL MANAGEMENT

⁴ Quoted in Hardings, James, ‘China Tackles Bad Management’, *Fin. Times* (March 6, 1999).

A. RECAPITALIZATION OF STATE COMMERCIAL BANKS VS. MARKET DISCIPLINE

In recapitalizing the “big four”, the Chinese Government face the dilemma facing governments all over the world to restructure their bank system: The idea of a wholesale government rescue raises serious moral hazard problems, meaning a precedent is set whereby taxpayers will always pay for banker’s mistakes. But, if the government pushes banks to raise private capital, the risk is that banks will try to conceal their problems from the investors whose support they are seeking. Authorities worldwide apply different approaches in an intention to solve the conflict between recapitalization and market discipline. Some of these approaches are adopted by the Chinese government.

1. *Ex-ante* Recapitalization Vs. *Ex-post* Recapitalization

Ex ante recapitalization and *ex post* recapitalization denotes whether to recapitalize banks before, or after corporate restructuring. It is not necessary that one of them is friendlier to market discipline. It is important, however, for a country to choose a tactic that fits its special circumstances.

China chose to recapitalize the “big four” *ex ante* in 1998, which has proved to be a failure. The recapitalization scheme was neither good timed⁵ nor in the right size.⁶ Based on the lesson from the RMB270bn recapitalization of the “big four” in 1998, China has chosen to recapitalize the “big four” in a manner between the *ex ante* and *ex post* recapitalization. In 1999, four AMC’s were established to take over NPLs from the “big four” and to carry out corporate debt restructuring. The AMC’s issued bonds guaranteed by the MOF to the respective banks in exchange for NPLs at their paper value. Because the bonds issued to the banks in exchange of the NPLs are Treasury-backed bonds, this transaction is in essence an injection of capital to the “big four”. As will be shown below, however, the AMC practices in China bear moral hazards as well.

⁵ As part of its anti-deflation monetary policy, the PBOC in 1998 directed the “big four” to continue to extend additional loans to loss-making SOEs, creating expectation on the part of banks that additional recapitalization funds would inevitably be forthcoming.

⁶ The RMB270bn recapitalization of the “big four” undertaken in August 1998 fell far short of the recapitalization amount that they would ultimately require.

2. Private Sector-based Solution & Conditioning Public Support

To avoid the conflicts between public bailout and market discipline, authorities in Asian crisis countries endeavored to achieve a private sector-based resolution, rather than a complete state bailout of distressed banks. Besides, public support was conditioned upon matters such as cost reduction, and increase in return on assets. In countries such as South Korea and Thailand, Memoranda of Understanding (MOUs) were used to document conditions. Moreover, the bank recapitalization itself in these crisis countries has been a process to enhance prudential regulation and supervision.

Some efforts are taken by the Chinese Government to mitigate the conflicts between the government capital injection and market discipline, based on the lessons of the RMB270bn capital injection in 1998 and the experiences of Asian crisis countries. The “big four” have been warned that the recapitalization carried out by the AMCs would be the last such injection and bankers would henceforth be subject to strict new disciplines. Besides, a cut-off is made — AMCs only take over NPLs issued prior to January 1, 1996, while banks are left on their own to deal with NPLs issued afterwards. More importantly, the “big four” are required to sign “governance contracts” with the PBOC, which set out performance goals and establish the board of supervisors in each bank. Last but not least, efforts are being made in China to enhance prudential banking regulation and supervision, as well as to promote bank internal controls. All these efforts can mitigate the moral hazards that accompany the government recapitalization. Because the “big four” will remain solely State-owned, however, it will be too optimistic to predict that they can implement efficient financial discipline over SOEs after the recapitalization.

B. AMC PRACTICES IN CHINA: CAN AMCS IMPOSE MARKET DISCIPLINE ON SOES?

1. Characteristics of AMCs in China

NPLs accumulated in a country's banking system can be dealt with in various ways. The centric-AMC approach is strongly recommended by the IMF to deal with bank NPLs in countries facing a systemic NPL problem because of its macro-economic and micro advantages compared with other methods.

China mainly followed the centric-AMC approach. Instead of only having one AMC, however, four separate AMCs were established — *i.e.* — the Cinda AMC for CCB, the Dongfang (Oriental) AMC for the BOC, China Great Wall AMC for the ABC, and China Huarong AMC for the ICBC. This quasi-centric approach based on the primary role of State-owned AMCs guarantees that NPLs in each of the “big four” would be tackled without delay. Besides, the bank-specific structure allows AMCs to make good use of banks' information about the debtors.

In addition to the bank-specific structure, AMC practices in China bear other characteristics. First, AMCs in China are solely State-owned — the MOF capitalized them with RMB10bn each. Second, AMCs in China bear a heavy administrative color. They are put at the same level as the PBOC on the “administrative ladder”. The board members of AMCs are mostly government officials, rather than experts in law, accounting and finance. Third, AMCs in China are granted a wide business scope and powers. They can engage in both commercial and investment banking activities and have great discretion in managing NPLs, including selling the bad assets to foreign investors. The four AMCs enjoy several preferential policies given by the State, including an exemption of registration fees and purchase and transaction taxes.

2. The Debt-Equity Swap Scheme in China

China's AMCs are authorized to employ both asset disposal (asset management) and debt restructuring (loan management) strategies towards collected NPLs. So far, AMCs in China have mainly carried out loan management strategies in the form of debt-equity swap.

The SETC announced the initiation of the debt-equity swap scheme on August 3, 1999. Under the SETC's debt-equity swap scheme, the four AMCs, together with the SDB, forgive debts owed by SOEs to them in exchange for equity stakes in their debtors. Not all SOEs are eligible for this scheme. Enterprises must satisfy several conditions before their

debts can be converted into equity. The SETC recommended 601 candidate enterprises for the scheme. AMCs are required to choose enterprises from the SETC recommended list; and if they choose any enterprise out of the recommended list, an approval from the SETC is required.

3. Problems with China's AMC Practices

Setting up four AMCs to tackle the NPLs of the “big four” is a great step forward in restoring market discipline in China. As mentioned before, it is unrealistic to expect banks that are heavily exposed to SOEs to impose financial discipline on their SOE borrowers. In this sense, AMCs, by taking NPLs off the balance sheets of the “big four”, help restoring their financial discipline vis-à-vis SOEs. Besides, AMCs are better positioned to impose financial discipline on their debtor SOEs because of their wider business scope and powers. It is expected that after the debt-equity swaps, AMCs, as shareholders of SOEs, can help to restructure the SOEs and improve the firms' corporate governance. This author, however, is not so optimistic about the success of AMC practices in China. AMCs in China lack both the capacity and incentives to impose market discipline on SOEs. Moreover, their tasks are self-conflicting.

(i) *The Dilemma Faced by Chinese AMCs*

AMCs in China are not only charged with releasing the banks of their NPLs, but are also mandated to rescue as many “viable” SOEs as possible. These two tasks cause a dilemma to AMCs. As creditors to SOEs, they should maximize their recovery from SOEs; while at the same time they should help SOEs out of their difficulties, AMCs will therefore have to compromise their creditor's rights sometimes. This dilemma has greatly limited their discretion in managing bank NPLs.

It will be unrealistic to propose that China should ignore its SOE problem and put emphasis solely on the bank side, because without solving the SOE problem, the bank NPL problem cannot be really solved. AMCs in China, however, should be released of their burden to save SOEs so that they can impose disciplines on SOEs as creditors or shareholders

(after debt-equity swaps). It should be the government's duty, rather than that of the AMCs' to bail out those economically and socially important SOEs.

(ii) *AMCs' Capacity and Incentive Problem*

Whether AMCs in China will have sufficient capacity and incentives to deal with NPLs remains doubtful. Given their heavy administrative color, the possibility of government interference is not remote. Besides, the state-ownership means that the Government will eventually take care of the NPLs that the AMCs fail to work out or recover, hence creating disincentives for AMCs to do their best to avoid unloading debt into the Government.

The capacity and incentives of AMCs' to deal with NPLs appropriately is also affected by the dependence of AMCs on their banks. One advantage of AMCs over banks in managing NPLs is that AMCs will not be scared to investigate the causes of NPLs. This advantage will be lost, however, if AMCs are dependent on the banks they have a liaison with.

In China, All four AMCs are carved out of former investment and trust companies subject to respective banks. Their staffs come from the banks as well. Officials from the "big four" sit in the board of supervisors of the AMCs. Their leadership appears to have close ties with the banks. Moreover, because the AMCs lack a network of branch organizations themselves, when they deal with local borrowers, they will have to rely on the bank branch network.

In addition, the lack of expertise and experience also impedes AMCs' smooth operation in China. Handling NPLs requires skills and experiences in various fields. The AMCs in China are not well equipped with personnel and expertise to manage the huge amount of NPLs collected from the banks.

Last but not least, because there is no precise method for evaluating NPLs and loan collateral in China, the AMCs have taken NPLs at their face value from the "big four". This face-value take-over creates difficulties in appraising the AMCs' performance and creates disincentives for AMCs to maximize the recovery of NPLs. The valuation problem also creates difficulties for AMCs in NPL disposal and debt restructuring.

To solve the incentive problem, emphasis should be placed on the accountability of AMCs. AMCs should be required to report periodically to the MOF and the PBOC about

their work. Public auditors should be employed by the MOF to audit the main transactions conducted by AMCs. More importantly, personal liabilities should be imposed on those AMC officials who fail to carry out their duty rightly. Regarding AMCs' capacity, China might be able to turn to those big name international investment banks for help. Setting up joint venture asset management companies might be a solution. Or at least, the four AMCs should be able to recruit expert worldwide.

(iii) *Moral Hazards Accompanying the Debt-Equity Swap Scheme*

Moral hazards are the biggest risk that needs to be safeguarded against to implement the debt-equity swap scheme. Respecting the debt-equity swap scheme in China, moral hazards exist in three aspects.

First, local governments and SOEs are competing to have their debts swapped. The selection of candidate enterprises by the SETC surely can solve the moral hazard problem to some extent. This practice in itself creates moral hazards, however. Since the final decisions are not made by AMCs but by the SETC, AMCs will have an excuse when a deal proves unsuccessful later on. It is therefore important to grant AMCs at least the discretion not to carry out debt-equity swaps with SETC recommended enterprises so that they can double check the financial situation and the potential of an enterprise before they carry out the swap with the enterprise.

Second, most of the debt-equity swap agreements signed so far do not include a workable plan to reorganize the enterprise. That makes debt-equity swaps like paper game (to increase enterprise book profits by reducing its interest payment) and equal to debt amnesty.

Last but not least, AMCs have difficulties in disposing of the equity they acquired via the swaps, while the exit of AMCs is essential to the success of the debt-equity swap scheme. At the end of the day, AMCs must cash banks in return for NPLs (which they currently pay in bonds). If AMCs can neither receive dividends from SOEs nor cash in the equity they acquired via the swaps, they will have no resources to pay the banks. Consequently, banks will have no way to repay depositors, and the Government will ultimately have to take the responsibility for repayment.

4. A Necessary Legal Framework for NPL Management in China

(i) *An AMC Law Should Be Adopted by the NPC or Its Standing Committee*

The AMC practices in China are mainly based on State Council Regulations and the SETC rules; while in most other countries, AMCs are established and operated on the basis of laws adopted by legislators-usually the parliament. An AMC Law is needed in China because of the probable conflicts between AMC practices and laws adopted by the NPC or its Standing Committee. These conflicts can only be solved by special legislation of the NPC or its Standing Committee, rather than by State Council Regulations. In addition to the need for proper statutes spelling out the statutes, the business scope, and powers of the AMCs, there are special legal issues that need to be sorted out by the NPC or its Standing Committee for AMCs to operate smoothly in China: (1) The notification obligation under the Contract Law should be waived when banks assign the NPLs to AMCs. (2) The procedures for the transfer of security interests should be simplified by the AMC Law. (3) AMCs' liability to debtors should be waived by the AMC Law.⁷

(ii) *Updating China's Banking and Bankruptcy Legislation so that Banks Will Have Incentives to Be Positive Creditors*

The creditor passivity of the banks is not uncommon in China. Instead of enforcing the loan contract against defaulting debtors, banks often choose to simply reschedule or roll over their loans. Banks seldom initiate bankruptcy cases against enterprises. And, as an adjunct to banks' reluctance in directing an enterprise into bankruptcy, the banks also become unwilling and sometimes strongly adverse participants in reorganization or compromise proposals. Making matters worse, banks are often required by the government to subsidize enterprise reorganization. The causes of creditor passivity are complex. The disincentive factors within China's banking law and bankruptcy law, however, have certainly contributed to the creditor passivity of the banks in China.

The disincentive factors within the banking regime include the soft budget constraints in State commercial banks, inadequate loan classification and provisioning rules, and the

⁷ See relevant discussion in Chapter 2.

banks' lack of autonomy in writing off NPLs. A new loan classification system has already been introduced into China. If the "big four" remain solely State-owned, however, it is hard to expect that their soft budget constraints can be really hardened. And, without granting them autonomy in charging off bad assets, bank management will not be willing to initiate bankruptcy cases against their hopeless borrowers. It is therefore necessary to change relevant rules in the banking regime so that banks will have incentives to be positive creditors.

Problems with China's bankruptcy legislation, including problems with bankruptcy procedures and the pro-employee asset distribution rules, have greatly contributed to the creditor passivity of the banks in China.⁸ Unless these rules can be changed, it will not be too pessimistic to predict that banks will remain passive in enforcing loan contracts. And, AMCs will have to count how much they can achieve by filing bankruptcy cases against their debtor enterprises and must be cautious in doing so. Consequently, they will not impose any market discipline on SOEs harder than that imposed by the State commercial banks.

(iii) Establishing An Appropriate Framework to Facilitate Negotiation between Creditors and Debtors

Debt restructuring has become the main tool for Chinese AMCs to deal with NPLs they collected from the banks. The current debt restructuring in China, however, is mainly orchestrated by the government. AMCs in China are almost solely applying debt-equity swaps. There is no report of the use of other debt restructuring tools. One of the reasons, from the author's point of view, is the absence of an appropriate framework to facilitate the negotiation between creditors and debtors.⁹ Consequently, the creditors and debtors can do nothing without the orchestration of the government. It is therefore necessary to develop a consensual mechanism to facilitate the negotiation for debt restructuring in China.

The author suggests that China develop an out-of-court mechanism similar to the London Approach and its variations in Asian crisis countries. The out-of-court mechanism should at least include a neutral party to co-ordinate the negotiation between the debtor and its creditors, the limitation on the ability of small creditors to block agreements, the seniority

⁸ See relevant discussion in Chapter 3.

⁹ Examples of such consensual mechanisms are discussed in Annex VI.

of the interim new financing over existing debt and a “standstill” on creditors. The SETC and the PBOC should jointly establish a special committee to co-ordinate the negotiation between creditors and debtors regarding debt restructuring. The decisions made by the committee should bind both parties.

5. Conclusion

AMCs are better positioned than State Commercial banks to deal with NPLs and impose market discipline on SOEs. If the problems listed above cannot be solved properly, and if an appropriate legal infrastructure cannot be put in place, however, it might not be pessimistic to predict that AMCs would not impose harder discipline on SOEs than banks.

V. NPL PREVENTION: DEVELOPING A PARTNERSHIP RELATIONSHIP BETWEEN BANKING REGULATION AND MARKET DISCIPLINE

A. WHY A PARTNERSHIP RELATIONSHIP BETWEEN BANKING REGULATION AND MARKET DISCIPLINE?

A partnership relationship between banking regulation and market discipline is necessary because of the limitations of both market discipline and financial regulation. Actually, the rationale of regulation is exactly the rationale of market discipline.

1. Rationale of Regulation, Rationale of Market Discipline

Various grounds have been given to account for regulation. Among them, three views will help us to understand the relationship between market discipline and prudential regulation. The first is that the regulation exists for the public good. This view sees market failure,¹⁰ such as the existence of natural monopoly or externalities, as *prima facie* evidence in favor of

¹⁰ Summaries of the theories of market failure can be found in: Bator, Francis M., ‘The Anatomy of Market Failure’, 72 *Quarterly Journal of Economics* 3, 351 (1958); and Baumol, William J., *Welfare Economics and the Theory of the State* (1965). For a more recent survey, see Stiglitz, Joseph E., et al., *The Economic Role of the State* (1989).

government regulation. In this view, regulation as a remedy to the market failure should and must play in coordination with market forces.¹¹

The second view, the “capture” or “specific interest” theory, sees regulation as implemented and operated for the benefit of politically powerful special interest groups, rather than for the public interest.¹² In this view, even if regulation is implemented for the public good, regulatory agencies tend to become captured by regulatees or by other special interests. This model reminds us of the risk that regulation is being used for special interest groups and hence the importance of market forces in checking that regulation is being properly used.

A third view extends the second analysis in recognizing that regulators and legislators are not passive agents of some special interests, but respond in purposeful ways to various incentives. According to this view, there is a dialectical process between bank regulation and innovation by market participants. Regulation imposed with good intentions leads to regulatees’ avoidance and a consequent decreasing of the effectiveness of the regulation and other, perhaps harmful, unintended effects. Political pressure and bureaucratic incentives lead to re-regulation.¹³ To avoid this negative dialectical process, there must be well-established regulatory objectives rooted in a clear understanding of why markets do not work well and how their functioning can be strengthened through government intervention.¹⁴

2. The Limitation of Regulation

No matter how advanced a regulatory system is there will be unregulated risks. The continuing incidence of financial instability and crises in industrial countries suggests that

¹¹ When reading the literature on the insufficiency of market, what should not be forgotten, however, is another strand of literature, that persuasively shows how political action, politicians, and bureaucrats, perhaps even more significantly than the market, can fail to coordinate the economy. See, e.g., Buchanan, James & Tullock, Gordon, *The Calculus of Consent: Logical Foundations of Constitutional Democracy* (1962); and Niskanen, William A., *Bureaucracy and Representative Government* (1971).

¹² See, e.g., Stigler, George J. ‘The Theory of Economic Regulation’, 2 *Bell Journal of Economics and Management* 3 (Spring 1971).

¹³ See, e.g., Kane, Edward J., ‘Accelerating Inflation, Technological Innovation, and the Decreasing Effectiveness of Banking Regulation’, 36 *Journal of Finance* 355 (May 1981); and ‘Good Intentions and Unintended Evil: The Case against Selective Credit Allocation’, 9 *Journal of Money, Credit and Banking* 55 (February 1977).

¹⁴ See, e.g., European Bank For Reconstruction and Development, *Transition Report 1998: Financial Sector in Transition*, iv (1998).

regulatory and supervisory reform is unlikely to provide fail-safe protection in this area. The limit to the effectiveness of regulation and supervision has various sources.

First, there is a continuing danger that new practices or transactions not yet adequately covered by the regulatory framework may prove a source of financial instability. And we can never be sure that all risks related to banking are under regulation.¹⁵

Second, there are growing difficulties regarding the transparency required for regulation and supervision. As a result of financial regulations, the balance sheets and other returns of many financial firms have an increasingly chameleon-like quality, which reduce their value to regulators.

Last but not least, the quality of most bank assets is susceptible to changes in the overall economic climate. No private-sector loan or other asset on a bank's balance sheet should be classified generically as "good".¹⁶ So long as cycles of financial boom and bust are features of the economic system, so also will be unforeseeable deteriorations in the status of many bank assets.¹⁷ Consequences of such boom-bust cycle were described in terms of the concept, "latent concentration risk" in recent literature on credit risk.¹⁸ Large exposure limitation cannot handle the "latent concentration risk".¹⁹ Whereas loan-loss provisions and higher prudential capital requirements can solve the problem to some extent, the financing associated with booms in the value of the property and other assets are difficult for

¹⁵ See Kane, Edward J., 'Metamorphosis in Financial Services Delivery and Production', in Federal Home Loan Bank of San Francisco, *Strategic Planning for Economic and Technological Change in the Financial Services Industry, Proceedings of the Eighth Annual Conference* (1983), where the author argued that the existence of unregulated risks was due to the fact that avoidance lags are shorter than regulatory lags. The differential lags reflect differences in the adaptive capacities of the regulated institutions and the regulators in response to changes in technology, market forces, or banking practices.

¹⁶ However reasonable the original managerial decision to make a loan and however justified its initial classification as low-risk by banking supervisors, the loan is vulnerable to the possibility of an eventual deterioration in its status. See Section C.3, Chap. IV, Part I in UNCTAD, *Trade and Development Report* (1998).

¹⁷ During such cycles risks take time to build up and become widely evident. For a while, indeed, the quality of loans can actually be enhanced by the very financing boom of which they are a part. Eventually, the effects of excess capacity generated by the boom and of the over-extended position of financial firms are likely to transform the boom into a movement in the opposite direction. See Akyuz, Yilmaz & Cornford, Andrew, *Capital Flows to Developing Countries and the Reform of the International Financial System*, UNCTAD Discussion Papers No. 143, 29-30 (November 1999).

¹⁸ See Caouette, J.B., E.I. Altman & Narayanan P., *Managing Credit Risk: The Next Great Financial Challenge*, 91, 240 (1998).

¹⁹ Traditionally, the concentration risk is handled in the context of banking regulation and supervision through limits on the size of exposures to particular borrowers. For this purpose "borrower" is typically defined to include groups of counter parties characterized by links due to common ownership, common directors, cross-guarantees, or forms of short-term commercial interdependency. See Basle Committee, *Measuring and Controlling Large Credit Exposure*, sect. IV. (1991).

supervisors to restrain with the measures at their disposal owing to the size of increases in expected income growth or capital gains which are frequently involved.

3. Conclusion

To sum up, market failures do justify regulation. There are, however, limitations with financial regulation as well. Therefore cares should be taken to make sure that regulations are complemented by doing what is possible to strengthen market forces.

B. THE DEVELOPMENT OF PRUDENTIAL BANKING REGULATION IN CHINA AND ITS COMPATIBILITY WITH MARKET DISCIPLINE

Despite all the progress China has made in developing banking regulation and supervision in line with international standards,²⁰ there are incompatibilities between China's banking regulation and market discipline. Efforts need to be made to develop a partnership relationship between market discipline and banking regulation in China.

1. Fostering Competition Should Be One of the Objectives for Banking Regulation and Supervision in China

The objectives for banking regulation and supervision are clearly defined by both the Central Banking Law and Commercial Banking Law in China. Accordingly, there are two objectives for banking regulation and supervision — to ensure the safety and soundness of commercial banking and to protect the legitimate rights and interests of depositors and other clients and other public interests.²¹

As have argued in Chapter One, the lack of competition in China's capital market, especially the domination of State commercial banks, has seriously undermined the market discipline. In the long run, a captive financial market is in conflicts with the objectives of

²⁰ See relevant discussion in Chapter Three.

²¹ The Law of the People's Republic of China on the People's Bank of China, adopted at the 3rd Session of the Eighth National People's Congress on March 18, 1995, effective as of the same day, art. 30; and the Law of People's Republic of China on Commercial Banks, adopted at the 13th Session of the Standing Committee of

ensuring the safety and soundness of commercial banking and protecting depositors and other public interests. It is therefore necessary to have a third objective for banking regulation and supervision in China, *i.e.*, to foster a more competitive banking market.

2. Removing Administrative Controls on Banks Completely

Administrative controls on banking activities undermine the good functioning of market discipline. To date, most of the administrative controls have been removed or relaxed. Interest rate controls, however, are still featuring China's banking system. As discussed in Chapter One, among all the restrictions, interest rate controls do the greatest harm to the good functioning of market discipline. To restore market discipline in China, interest rate controls over bank deposit taking and lending will have to be removed.

3. Promoting Disclosure Standards and Accounting Practices

Market discipline requires that market participants can make informed judgments. This demands more disclosure of bank data, because if the marketplace is to play its role effectively, it must have adequate and reliable information via disclosure.²² Appropriate disclosure is also crucial to effective banking supervision. Principle 21 of the Basle Committee Core Principles for Effective Banking Supervision reads as follows:

Banking Supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with consistent accounting policies and practices that enable the supervisor to obtain a true and fair view of the financial condition of the bank and the profitability of its business, and that the bank publishes on a regular basis financial statements that fairly reflect its conditions.

China's Commercial Banking Law contains disclosure requirements as well. Article 55 of the Law provides that a commercial bank shall truthfully and in an all-round way record and reflect its business activities and financial position, produce its annual financial accounting report and timely submit its financial statements to the PBOC and the treasury

the 8th National People's Congress on May 10, 1995, and effective as of July 1, 1995 (hereinafter referred to as "the Commercial Banking Law"), art. 1.

²² See, *e.g.*, 'Survey: Prevention is Much Better than Cure', 350 *The Economist* 8104 (January 30, 1999).

department. A commercial bank shall not establish accounting books other than those legally specified. Commercial banks are also required to announce their business performance and audited statement of the previous fiscal year within three months after the end of every fiscal year in accordance with the stipulation of the PBOC.²³ The problem is that these rules have never been implemented fully.

According to Nicholas Lardy, except for the BOC, the largest State-owned banks did not disclose information on the quality of its loan portfolio and the magnitude of NPLs written off annually until 1998. Besides, except for the BOC, the rest of the “big four” did not present their balance sheets on a consolidated basis, allowing them to bury financial losses in their subsidiaries. More generally, both profit and loss statements and the balance sheets of most banks were presented on such an aggregated basis that it is difficult to evaluate their true financial condition.²⁴ The PBOC in 1996 acknowledged that some banks had lent funds “without recording them in their account books,” and that some non-bank institutions created “false assets” to cover up the “black hole” in their balance sheets caused by large financial losses.²⁵

The poor accounting and disclosure practices not only undermine the market discipline but also thwart effective banking supervision. Taking large exposure limit for an example, Chinese banks do not disclose any quantitative information on loan concentration so it is impossible to judge the extent to which they are in compliance with this prudential rule.

It is therefore necessary that more advanced accounting disclosure rules are developed in China, both for the good functioning of market discipline and a more effective banking regulation and supervision.²⁶

VI. DESIGNING AN APPROPRIATE BANKING SAFETY NET TO ENHANCE MARKET DISCIPLINE AND PRUDENTIAL REGULATION IN CHINA

²³ The Commercial Banking Law, *supra* note 21, art. 56.

²⁴ See Lardy, Nicholas R., *China's Unfinished Economic Revolution*, 169 (1998).

²⁵ *Id.*, at 206.

²⁶ Fortunately, progresses have been made in this area. In November 2000, the CSRC issued rules on disclosure by listed financial companies (including banks). Accordingly, listed commercial banks should comply with the PBOC system of classifying assets in five categories. In their statements, banks should disclose at least three

A. THE OVERALL CONSISTENCY BETWEEN THE BANKING SAFETY NET AND MARKET DISCIPLINE

1. The Inherent Moral Hazard Problem

The Moral hazard problem has been puzzling the proponents for central bank's LOLR, deposit insurance system and bank insolvency resolution even since the first day they were proposed. A LOLR bears moral hazards, especially when it is not properly provided. If banks can always expect to get easy loans from the central bank whenever they come across liquidity problems (or even solvency problems), bank management will become incautious in watching the asset liquidity of the bank. Public deposit insurance encourages bank owners and managers (particularly in troubled banks) to take irresponsible or excessive risks and to hold less capital than if bank deposit were not insured. In the case of bank insolvency resolution, moral hazards will be presented because most of the regulatory options contain government aids, *i.e.*, funding coming directly or indirectly from the government.²⁷ Making matters worse, in some cases, an implicit or explicit "too big to fail" will not only induce moral-hazard-behavior, but may also pose questions of fair competition.²⁸

The author has no intention to deny these charges. But if we try to understand the issue from another angle, however, we might be able to conclude that a well-designed safety net is essential for the good functioning of market discipline by facilitating banking regulators to impose market discipline on individual banks without jeopardizing the entire banking system.

2. Understanding the Safety and Soundness Properly

years' figures for their total debts and deposits, as well as their NPLs. See AFX News, 'CSRC Issues Rules on Disclosure by Listed Financial Companies' (November 14, 2000), *available at* '2000 WL 29253899'.

²⁷ There are four sources of external funding in the case of bank failures: banks, the central bank, the government or deposit insurance. However, funding from the deposit insurance or from the central bank can be an indirect way of granting government funding, thus exposing the interests of taxpayers. See generally Goodhart, C. & Schoenmaker, D., *Institutional Separation Between Supervisory and Monetary Agencies*, LSE Financial Markets Group, Special Paper No. 52 (April 1993).

²⁸ See, *e.g.*, Lastra, R. M., *Central Banking and Banking Regulation*, 136-7 (1996).

The safety and soundness of banking institutions is considered as the primary goal of banking regulation all over the world.²⁹ The understanding of the goal, however, is not always the same — although it is agreed that the overall goal of bank regulation is to maintain public confidence in the banking system, *i.e.*, the protection of the system as a whole,³⁰ the goal of safety and soundness can also be interpreted as the protection of depositor accounts or the protection of individual institutions.³¹ A banking safety net is therefore necessary because it help to resolve this inconsistency.

In the absence of a LORL and the deposit insurance, it is difficult for banking regulators/supervisors to distinguish between the protection of depositor accounts, the protection of the system as a whole, and the protection of individual institutions. The failure of an individual institution may lead to runs on or failures of other institutions — institutions that were well run and sound. The protection of individual institutions would then be necessary to protect depositors of the given institution as well as of other institutions. The advent of a LOLR and the deposit insurance, therefore, to some extent frees regulators from the need to preserve individual institutions.³² In some cases, orderly liquidation of troubled institutions, with a guarantee against loss by liquidation, isolated the problem so that it cannot spread to other institutions. It is in these senses that the author argues that a banking safety net is in overall consistent with market discipline.

B. THE BANK SAFETY NET MUST BE WELL-DESIGNED AND OPERATED

The overall consistency between a banking safety net and market discipline cannot be taken for granted. The harmony can only be attained if the bank safety net is well designed and properly carried out.

To avoid or mitigate the conflicts with market discipline, the LOLR function of the central bank should be used only to alleviate short-term liquidity problems, by lending at a

²⁹ This is not surprising given the fact that the banking regulation regime in most countries was first established in the wake of financial crises with numerous bank failures. *See, e.g.*, Harif, William S. & Kushmeider, Rose Marie (eds.), *Restructuring Banking & Financial Services in America*, x (1988).

³⁰ *See* Sinkey, Joseph F. Jr., 'Regulatory Attitudes toward Risk', in Aspinwall, Richard C. & Eisenbeis Robert A (eds.), *Handbook for Banking Strategy*, 349-50 (1985).

³¹ *See* Peterson, Manfred O., 'Regulatory Objectives and Conflicts' in Aspinwall, Richard C. & Eisenbeis Robert A. (eds.), *Handbook for Banking Strategy* (1985).

³² For example, with depositors protected by government deposit insurance, the experience since 1934 in the U.S. indicates that failure of one bank seldom leads to runs on other banks. *Id.*

penalty rate on good collateral. Moreover, central banks must assure the sterilization of liquidity supports to banks.³³ To achieve this, the conditions and procedures to provide LOLR should be clearly defined in China's Central Banking Law.

The design and operation of a deposit insurance system might be the most complicated part. The scope and coverage of the deposit insurance system should be limited so that at least depositors will have some incentives to monitor banks. More importantly, the government should adhere to its commitment to pay out only those deposits that fall within the terms of the guarantee and no others whenever the deposit insurance system is put to the test. China needs to replace its government implicit guarantee with an explicit deposit insurance scheme and include all these rules in its new deposit insurance system.

With regard to insolvency resolution mechanisms, it is essential that insolvent intermediaries would be closed promptly when net worth on a market-value accounting basis declines to zero.³⁴ Moreover, banking supervisors and regulators should ensure that the risk is borne by equity owners of the intermediaries by adequate capital requirements. Basic regulatory options to deal with a failed bank include closure and liquidation, a rescue package, merger and take over, and bridge bank (*e.g.*, management take-over in China). To date, all these mechanisms have been applied in some form in China, although the Commercial Banking Law only provides about the management take-over and liquidation (including bankruptcy) of commercial banks. There are problems with China's recent financial institution insolvency resolution practices. China needs to develop a solid legal infrastructure for bank insolvency resolution.

VII. CONCLUDING REMARKS

All four conditions for market discipline are absent in China. The malfunctioning of market discipline in China lies at the root of the bank NPL problem. A comprehensive bank

³³ Sterilization enables central banks to recycle liquidity from banks gaining deposits to those losing deposits and credit lines.

³⁴ See, *e.g.*, Benston, George J., Eisenbeis, Robert A., Horvitz, Paul M., Kane, Edward J. & Kaufman, George G., *Perspectives on Safe and Sound Banking: Past, Present and Future*, 37-42, 91-93 (1986). If the bank is declared legally insolvent at the exact moment the market value of its net worth reaches zero (*i.e.*, at the point of economic insolvency), direct losses are only suffered by shareholders. If the bank is declared legally insolvent when the market value of its net worth is already negative, losses will accrue to not only shareholders but also uninsured creditors and/or to the insurance fund. The longer an economically insolvent bank is allowed to continue operations, the higher the cost to the insurance fund. *Id.*

restructuring is therefore necessary to restore the market discipline on State commercial banks and SOEs.

China has established four AMCs to take over the NPLs from the “big four”. There are problems with the current AMC practices in China. If these problems cannot be solved properly, it is hard to expect that AMCs can do any better than State commercial banks to discipline the SOE borrowers. Besides, caution needs to be taken to avoid or at least to mitigate potential conflicts between government recapitalization and market discipline.

The creation of new NPLs must come to a halt, by enhancing banking regulation and promoting bank internal controls. The development of banking regulation and supervision, however, should not suppress market forces.

An appropriately designed banking safety net comprising LOLR, deposit insurance and bank insolvency resolution helps banking regulators and supervisors to distinguish between the protection of depositor accounts, the protection of system as a whole, and the protection of individual institutions and therefore focus themselves on maintaining the public confidence in the banking system, so as to achieve a harmony with market discipline.

The AMC practices, the enhanced banking regulation and bank internal controls, and a bank safety net will certainly help to restore market discipline in China. The success of these schemes, however, depends heavily on whether a solid legal framework can be put in place to facilitate the comprehensive bank restructuring, including laws relating to AMC practices in China, legislation on prudential banking regulation, and legislation on banking safety net.

P248

P248

P248

Blank Page

ANNEX

- ANNEX I: CHINA'S FINANCIAL INSTITUTIONS (EXCLUDING SECURITIES AND INSURANCE COMPANIES) AND THEIR ASSETS BY THE END OF 1998
- ANNEX II: THE SEVEN INTEREST RATE CUTS FROM MAY 1996 TO JULY 1999 (ANNUAL INTEREST RATES IN PERCENTAGE FORM)
- ANNEX III: REGULATORY FORBEARANCE — EXPERIENCES OF THE US AND JAPAN
- ANNEX IV: TECHNIQUES TO HELP BANKS IN DISTRESS — EXPERIENCES OF ASIAN CRISIS COUNTRIES (FROM THE GOVERNMENT'S POINT OF VIEW)
- ANNEX V: A BRIEF DESCRIPTION OF CHINA'S FOUR AMCS
- ANNEX VI: CONSENSUAL MECHANISMS FOR CORPORATE DEBT RESTRUCTURING
- ANNEX VII: THE CONCILIATION AND REORGANIZATION PROCEDURE UNDER CHINA'S ENTERPRISE BANKRUPTCY LAW
- ANNEX VIII: CHINA'S MAIN BANK SYSTEM
- ANNEX IX: GENERAL PRINCIPLES FOR CORPORATE DEBT RESTRUCTURING IN THAILAND
- ANNEX X: THE EVOLUTION OF THE PBOC AS A BANKING REGULATOR AND SUPERVISOR
- ANNEX XI: THE PBOC'S INDEPENDENCE AND AUTONOMY, THE PBOC'S ORGANIZATIONAL RESTRUCTURING, AND THE DIVISION OF FINANCIAL SUPERVISORY DUTIES BETWEEN THE PBOC HEADQUARTERS AND ITS BRANCHES

- ANNEX XII: THE DEVELOPMENT OF BANK LOAN CLASSIFICATION AND PROVISIONING SYSTEM IN CHINA
- ANNEX XIII: SUMMARY TABLE OF PCA PROVISIONS OF THE FEDERAL DEPOSIT INSURANCE CORPORATION IMPROVEMENT ACT 1991
- ANNEX XIV: THE DEVELOPMENT OF BOARD OF THE SUPERVISORS IN STATE COMMERCIAL BANKS
- ANNEX XV: EFFORTS OF THE PBOC TO HELP COMMERCIAL BANKS OBTAIN EXTERNAL INFORMATION
- ANNEX XVI: THE GITIC BANKRUPTCY CASE
- ANNEX XVII: CHINA EVERBRIGHT BANK'S ACQUISITION OF CHINA INVESTMENT BANK'S COMMERCIAL BANKING ASSETS

PAGE/PAGES
EXCLUDED
UNDER
INSTRUCTION
FROM
UNIVERSITY

PAGE/PAGES
EXCLUDED
UNDER
INSTRUCTION
FROM
UNIVERSITY

ANNEX III: REGULATORY FORBEARANCE — EXPERIENCES OF THE US AND JAPAN

1. The Failed Regulatory Forbearance Policies towards the Thrift¹ Crisis in the US

The experience of the US thrift industry in the 1980s exemplifies the risk of regulatory forbearance. Beginning in 1979, the mutual saving banks and savings and loans associations suffered severe losses.² In 1981, 85% of the nearly 3,800 thrift institutions insured by the Federal Savings and Loan Insurance Corporation (FSLIC) had negative earnings.³ The FSLIC, facing a record number of problem thrift institutions, responded by merging or liquidating the weakest institutions, but allowing many of them to remain open. In 1982, the Congress codified this pattern of loose regulatory enforcement in the Garn-St Germain Act. The legislation relaxed accounting standards for thrifts and broadened the types of assets they could hold. The authorities chose the tactic of regulatory forbearance largely because the resources available to the FSLIC were grossly inadequate to pay off depositors of the thrifts that should have liquidated.⁴

During the mid-1980s the government encouraged adequately capitalized “healthy” thrifts to acquire inadequately capitalized “sick” thrifts. Such acquisitions, commonly referred to as “supervisory mergers,” were orchestrated by the Federal Home Loan Bank Board (FHLBB) and the FSLIC. The government preferred merging insolvent thrifts rather

¹ The term “thrift” encompasses various types of state and federally chartered financial institutions, including building and loan associations, savings and loan associations, cooperative banks, homestead associations, and savings banks. Traditionally, thrifts accepted funds from individual depositors and then loaned them to the public in the form of single-family home mortgages. See 12 U.S.C. § 1424 (1988) (amended 1989).

² See Savage, Donald T., ‘Depository Financial Institutions’, in Aspinwall, Richard C. & Eisenbeis Robert A. (eds.), *Handbook for Banking Strategy* (1985).

³ This was the worst of a series of increasingly un-profitable years for S & Ls. More significantly, the 1979-81 surge in interest rates wiped out the industry’s net worth, as measured by current market value. Even by the most lenient standards of generally accepted accounting principles, the financial health of thrift institutions deteriorated markedly during this period. See Romer, Thomas & Weingast, Barry R., ‘Congress: The Genesis of the Thrift Crisis’, *Stan. L. & Pol’y Rev* 37, 37 at 37 (Spring, 1990).

⁴ ‘GAO Estimates FSLIC Ran out of Money in 1986, Incurred \$3 Billion Deficit’, *Banking Report* 422 (March 9, 1987). According to the former Chairman of the US League of Savings Institutions, “The hope [in the early 1980s] was [that] we could get through this first hump, that interest rates would go down, and [that] we could save the bulk of the industry.” Cited in Felsenfeld, Carl, ‘The Savings and Loan Crisis’, 59 *Fordham L. Rev.* S7, S 28 (May 1991).

than liquidating them because supervisory mergers were believed to be less costly to the government and less disruptive to the insolvent thrift's depositors and borrowers.⁵

To encourage healthy thrifts to acquire sick thrifts, the FHLBB and FSLIC typically provided acquirers with financial assistance and forbearance agreements.⁶ The terms contained in these forbearance agreements varied in substance depending on the transaction, but generally the agreements contained the FHLBB's or the FSLIC's⁷ expressed promise to refrain from enforcing the already relaxed capital requirements or mandating the use of accounting standards.⁸ Mergers were arranged on an interstate basis, and both bank holding companies and some non-thrift firms were allowed to acquire S&Ls.⁹

In order to minimize the amount of FSLIC financial aid required, the FSLIC reduced by two-fifths the minimum net worth ratios required for thrifts to maintain in operation, and when proved inadequate, issued outright exemptions so that thrifts that failed to meet the new lower capital requirements could continue to operate. The Competitive Equality Banking Act of 1987 required that the FHLBB forebear against thrifts with regulatory net worth of more than 0.5% and whose low capital could be attributable to adverse economic conditions. In some cases even S & Ls with net worth of less than 0.5% were eligible for forbearance. Since regulatory capital often overstates the market value of capital by a large margin, these provisions ensured that a substantial number of firms would continue to operate with effectively no equity funds at risk.¹⁰ At the end of 1987, for example, over 500 insolvent S & Ls continued in operation.¹¹

⁵ See Levitt, Michael S., 'The Abrogation of Forbearance Agreements: FIRREA's Ambiguities Demand A More Principled Analysis', 61 *Geo. Wash. L. Rev.* 1314, 1314-5 (June, 1993).

⁶ See Coe, Linda B., 'Abrogation of Forbearance Agreements: Unauthorized by FIRREA and Unconstitutional', 59 *GEO. Wash. L. Rev.* 157, 158 (1990).

⁷ The FHLBB generally issued the forbearances for federally chartered institutions, and the FSLIC generally issued the forbearances for state chartered institutions. *Id.*, at 161.

⁸ Standard types of forbearances authorized and granted by the FHLBB and FSLIC included: (1) forbearance from enforcing regulatory capital requirements; (2) forbearance from requiring certain accounting requirements; (3) forbearance from curing deficiencies in liquidity requirements; (4) forbearance from compliance with investment limitations in service corporations; (5) forbearance from prohibitions on unauthorized service corporation activities; (6) forbearance from prohibition on operations and investments inconsistent with FSLIC regulations; (7) forbearance from compliance with investment limitations in owned office buildings; and (8) forbearance from requirements to restructure troubled debt. See Zisman, Barry S. & Churchill, William O., 'Federal Assistance Relating to Failing and Failed Thrifts', 8 *Banking Expansion Rep.* 1, 12 (1989).

⁹ See, e.g., Harif, William S. & Kushmeider, Rose Marie (eds.), *Restructuring Banking & Financial Services in America*, 23 (1988).

¹⁰ *Id.*, at 25.

¹¹ See, e.g., Hagermand, Deano & Gajewski, Gregory, 'Patterns of Financial Institution Failures: Some Thoughts on Policy Implications', *Federal Deposit Insurance Corporation Banking and Economic Review* 8 (May/June 1987).

The US Congress cooperated by eliminating Regulation Q interest rate ceilings on thrift institutions and authorizing “certain capital forbearance measures.”¹² To provide longer-run aid, regulatory limitations on variable-rate mortgages were reduced or eliminated and the Supreme Court removed barriers to the enforcement of due-on-sale clauses. The thrifts, along with the commercial banks, were given a variety of new deposit instruments. The 1980 Depository Institutions Deregulation and Monetary Control Act and the Garn-St Germain Act of 1982 also expanded the lending and investment powers of the thrifts in the expectation that their excessive concentration in mortgage could be reduced over time. Besides, Borrowings from the Federal Home Loan Banks increased, and a capital assistance program was initiated under the authorization of Garn-St Germain Act of 1982.¹³

All these facilitated the over-risk-taking by thrifts and consequently led to their failures.¹⁴ Because of the existence of deposit insurance, insolvent or nearly insolvent thrifts were able to continue to attract funds. By offering higher yields on deposit accounts, they could bid for funds nationwide using deposit brokers and direct advertising in an attempt to grow their way out of their problems. In an attempt to increase their profitability, in the mid-1980s thrifts abandoned their traditional focus on residential mortgage lending in favor of commercial real estate lending and investments in high-yield junk bonds. In this search for higher earnings that could be used to buttress their weak capital positions, the thrifts moved into unfamiliar business without fully understanding the greater risks involved.¹⁵

The regulatory forbearance tactics towards the thrift problem proved a financial disaster. The regulatory forbearance seemed to work over the next two years after the Garn-St Germain Act, with the fall of the number of thrifts that received direct or indirect FSLIC assistance. As interest rates declined, many observers came to believe that the crisis was over. Unfortunately, the period between 1983 and 1985 was just the calm before the storm. In late 1985, the FHLBB chairman Edwin Gray testified before the Congress that the FSLIC would require \$14-15bn in additional funds to handle the rapidly growing number of insolvencies. When Congress passed legislation nearly two years later in 1987, S & L

¹² See Andrew, Sheng, *Bank Restructuring: Lessons from the 1980s*, 77 (1996).

¹³ See Hagermand, Deano & Gajewski, Gregory, *supra* note 11.

¹⁴ Of the 20 largest depository institutions failing from 1934 to 1984, 17 have occurred since 1981 and of those, 16 were thrift institutions. The heavy losses incurred by thrifts in the U.S. as a result of interest rate volatility suggest a need for greater capital than for commercial banks. See Nagle, Reid & Petersen, Bruce, ‘Capitalization Problems in Perspective’ in Aspinwall, Richard C. & Eisenbeis Robert A. (eds.), *Handbook for Banking Strategy* (1985).

¹⁵ See Andrew, Sheng, *supra* note 12, at 79.

insolvency costs had grown to an estimated \$50bn.¹⁶ By the time bailout legislation was again considered in 1989, liabilities facing the FSLIC and American taxpayers had reached \$200bn,¹⁷ forcing the FSLIC into bankruptcy in 1989.

The adoption of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA)¹⁸ was an admission that the decade-long hope that the thrifts could grow their way back to solvency had failed. The scope of its regulatory reforms was expressed in the purposes of the Act:¹⁹ (1) to promote, through regulatory reform, a safe and stable system of affordable housing finance; (2) to improve the supervision of savings associations by strengthening capital, accounting, and other supervisory standards;²⁰ (3) to curtail investments and other activities of savings associations that pose unacceptable risks to the Federal deposit insurance funds; (4) to promote the independence of the Federal Deposit Insurance Corporation (FDIC) from the institutions the deposits of which it insures, by providing an independent board of directors, adequate funding, and appropriate powers; (5) to put the Federal deposit insurance funds on a sound financial footing; (6) to establish an Office of Thrift Supervision in the Department of the Treasury, under the general oversight of the Secretary of the Treasury; (7) to establish a new corporation, to be known as the Resolution Trust Corporation (RTC), to contain, manage, and resolve failed savings associations; (8) to provide funds from public and private sources to deal expeditiously with failed depository institutions; (9) to strengthen the enforcement powers of Federal Regulators of depository institutions; and (10) to strengthen the civil sanctions and criminal penalties for defrauding or otherwise damaging depository institutions and their depositors.

The FIRREA's most important contribution to the solution of the thrift crisis was its acknowledgement that taxpayer's money would be required to close all insolvent S & Ls.²¹ The FIRREA provided \$50bn over three years to close insolvent S & Ls, with additional funding available thereafter. The legislation also created the FSLIC Resolution Fund (FRD)

¹⁶ The 1987 legislation only provided \$10.8bn in additional FSLIC funding, less than regulators had requested in 1985. See Romer, Thomas & Weingast, Barry R., *supra* note 3, at 37.

¹⁷ *Id.*, at 38.

¹⁸ FIRREA, Pub. L. No. 101-73, 103 Stat. 183 (codified in scattered sections of 12 & 15 U.S.C.).

¹⁹ 12 U.S.C. § 1811 (Supp. III 1991).

²⁰ FIRREA, through its Minimum Capital Requirements provision, supplies the regulatory framework for the recapitalization of the savings and loan industry. The provision authorizes the Director of the OTC to establish minimum capital requirements.

²¹ By contrast, all previous legislative and regulatory actions understated the size of the problem and indicated that a combination of insurance premiums and special assessments on industry would cover the entire cost.

to cover S & L closing costs incurred before 1989. These funds were separated from the \$50bn made available to close insolvent S & Ls beginning in 1989.²²

With regards to the regulatory forbearance agreements, the OTC and RTC were empowered to review prior FHLBB and FSLIC cases respectively, including the terms contained in supervisory mergers.²³ “The Corporation [RTC] shall review and analyze all insolvent institution cases resolved by the Federal Savings and Loan Insurance Corporation between January 1, 1988, and the date of enactment of the Financial Institution Reform, Recovery, and Enforcement Act of 1989....”²⁴ Regarding the scope of the RTC’s power under its review duties, the provision states: The Corporation [RTC] shall exercise any and all legal rights to modify, renegotiate, or restructure such agreements where savings would be realized by such actions.²⁵

2. The Failure of Japan’s Regulatory Forbearance Policy and the U-Turn Afterwards

Japan’s banking crisis has been a slow-burn²⁶ crisis that has gradually unfolded during the course of 1990s.²⁷ At the heart of the problem was a vast amount of unrecoverable loans backed by commercial property, whose value has collapsed since the early 1990s,²⁸ to which has been added unrecoverable loans to companies from Japan’s long economic slowdown.²⁹

In 1993 the Ministry of Finance (MOF) and the Bank of Japan (BOJ) openly debated over how to respond to the deterioration in banks’ loan portfolios. The MOF argued that, in the interests of financial stability, banks should be encouraged to make only a gradual

²² See Barth, James R. & Brumbaugh, R. Dan Jr., ‘Savings & Loan Crisis: Lessons and A Look Ahead: The Rough Road From FIRREA to Deposit Insurance Reform’, 2 *Stan. L. & Policy Rev.* 58, at 58 (Spring, 1990).

²³ See Levitt, Michael S., *supra* note 5, at 1324-26.

²⁴ 12 U.S.C. § 1441a (b) (11) (B) (Supp. I 1989), amended by 12 U.S.C. § 1441 a (b) (11) (B) (Supp. III 1991).

²⁵ *Id.*

²⁶ The slow-burn characteristic may explain why Japan chose to have the banks reserve or write off loans on their own books.

²⁷ The genesis of the crisis can be traced to late 1970s when Japan started its financial deregulation. Following that period was the period from mid-to-late 1980s when rising asset prices supported by massive bank lending. The 1990s have seen falling asset prices, resulting in problems in the banking sector, and the government’s slow attempts to address them. See Ueda, Kazuo, ‘The Japanese Banking Crisis in the 1990s’ in *Strengthening the Banking System in China: Issues and Experience*, BIS Policy Papers No. 7, 251, at 251 (October 1999).

²⁸ Ueda, Kazuo identified the role of real-estate-related loans played in causing the NPL problem by tracing the movements of the price index for land and its relationships with the increase in real estate loans and the deterioration in overall loan quality. He finds out that the increase in real estate loans in the mid to late 1980s corresponding with sharp increases in land prices after the mid 1980s and the long period of large declines in loan prices in the 1990s is consistent with the view that this has been the major cause of the NPL problem. *Id.*, at 255.

²⁹ See generally Jon Choy, ‘Japanese Fiscal Policy: Testing Economic Theory And Political Will’ (April 30, 1999), available at ‘1999 WL 11606577’.

adjustment to their published accounts; while the BOJ advocated immediate large-scale write-offs even if that meant, for some banks, reporting actual losses in the 1993-4 fiscal year. The MOF's view prevailed. The regulatory authorities adopted a forbearance policy that allowed banks to understate the scale of their problem loans in the hope that the passage of time would eventually alleviate the situation.³⁰

The forbearance policy contained several key elements.³¹ First, in January 1993 the Co-operative Credit Purchasing Company (CCPC) was established by 162 financial institutions to acquire banks' troubled loans at a discount based on an independent valuation of the underlying property collateral. The CCPC's loan acquisition was, in theory, financed by those banks disposing of their loans. Those banks that transferred their assets to the CCPC were able to take off the loans concerned from their balance sheets and offset the resulting losses against tax. The CCPC, however, operated on a full recourse basis — *i.e.*, banks could be obliged to reacquire loans they "sold" if the agency failed to dispose the underlying property collateral.³²

Second, banks were evidently encouraged by the authorities to handle their troubled loans in ways that did not require recognition of losses or disclosure of non-performance. Typically, this involved restructuring loans at concessionary, and even near-zero, interest rates.³³

Third, the lax accounting rules in Japan helped banks to conceal their problems. Japanese banks applied "window dressing" widely to flatter their fiscal year results through a variety of accounting tricks every March.³⁴

Following the regulatory forbearance was the banks' deliberate concealing of the problem. The FSA's inspection of the country's largest 19 banks prior to the injection of

³⁰ See generally Beattie, Vivien A., *et al.*, *Banks and Bad Debts: Accounting for Loan Losses in International Banking*, 125 (1995).

³¹ *Id.*, at 125-7.

³² This, under UK or US supervisory rules, however, would prevent the loans concerned from being taken off the banks' balance sheet.

³³ It was estimated that if such restructured credits were classified as non-performing, they would then double the total NPLs reported by the 21 major banks at March 1993. See Beattie, Vivien A., *et al.*, *supra* note 30.

³⁴ "Window dressing" comes in many forms. At one of the spectrum, some Japanese institutions have engaged in *tobashi* — or the illegal practice of shuffling losses into secret accounts. But Japanese institutions have also used completely tricks to flatter their accounts such as temporarily selling high-risk assets to remove them from their balance sheet. Between these two extremes lie a multitude of gray trades. Western brokers have temporarily bought shares from Japanese banks to allow their Japanese clients to record a profit on their equity portfolios - before selling them back to the same bank. Meanwhile, western investment banks have also sold derivatives that can disguise losses. See, *e.g.*, Tett, Gillan, 'Banking: Japanese "Window Dressing" May Cost Dear', *Fin. Times* (April 6, 1999).

Y25,000bn of public funds into their capital base revealed that these banks had underestimated their risky loans by up to Y10,000bn.³⁵

The forbearance approaches carried out in the earlier stage of the crisis proved a failure. The equity of Japanese banks declined significantly to a level well below the Basle Accord standard, while loans classified as “behind in payment” down to “non-recoverable” totaled at least 77 trillion yen, or 15% of GDP in 1998.³⁶ The economic growth slowed down tremendously. After 1996, economic forecasts had caught up with the slow- growth reality and were no longer surprised by it.³⁷

In 1998,³⁸ the Financial Restructuring Commission (FRC) was established to oversee financial sector restructuring. Besides, the Financial Supervisory Agency (FSA) was spun off from the MOF in June 1998 to handle issues related to the banking crisis. Two bad loan collection and disposal agencies (the Resolution and Collection Bank and the Housing Loan Administration Corporation) were consolidated into a new agency — the Resolution and Collection Corporation. The new agency has expanded authority to purchase bad loans not only from failed banks but also from solvent institutions.³⁹ Legislation was enacted in October 1998 that sharply increased public funds available to deal with problem institutions,⁴⁰ toughened the conditionality for bank recapitalization with such funds, and created mechanisms for temporary nationalization of failed banks.⁴¹ Two major banks were nationalized in the late 1998.⁴² The first round of capital injection was finalized on March 30,

³⁵ See Tett, Gillian, ‘Japanese Banks’ Underestimated Bad Loans’, *Fin. Times* (November 26, 1998).

³⁶ See Posen, Adam S., ‘Financial Fragility and the Risks of Crisis: the Case of Japan’, 23-SPG Fletcher F. World Aff. 109, 118 (Winter-Spring 1999).

³⁷ *Id.*, at 121.

³⁸ Cf. Ueda, Kazuo, *supra* note 27. That author contemplates that the policy turning started as early as the beginning of the 1990s. Ueda divided the 1990s into three stages: The stage until 1994 is one in which banks and regulators started to recognize the seriousness of the NPL problem, with the first troubled banks to be closed, with the injection of deposit insurance funds into rescuing banks, with the Cooperative Credit Purchasing Company created in 1993 and banks starting to disclose bad loan numbers in 1993. The second stage started in late 1994 in which the regulators embarked on serious attempts at resolving problems with credit cooperatives and housing finance companies (jusen). The third stage started in 1997. The credit crunch resulted from the closure of three large banks and securities companies led to the government’s final decision to mobilize a large sum of public money to protect creditors of insolvent banks and to recapitalize some of the solvent ones. *Id.*, at 251-2.

³⁹ See ‘Annex II Banking System Developments and Corporate Sector Restructuring in Japan’ in IMF *International Capital Markets: Development, Prospects, and Key Policy Issues*, 28, at 38 (September 1999).

⁴⁰ To help banks meet the requirements, the government pledged Y60,000bn of public funds, consisting of Y25,000bn for injections into the banks’ capital base to help them provision for or write off NPLs. See, e.g., Tett, Gillian, ‘Sun Finally Rising on Japanese Banks: If Japan’s Economy is to Show New Signs of Life, Banks’ Bad Loans Must Be Written Off More Rapidly’, *National Post* (March 20, 1999), available at 1999 WL 13668538.

⁴¹ *Supra* note 39, at 28.

⁴² The Long-Term Credit Bank and Nippon Credit Bank were nationalized according to the Financial Reconstruction Law in 1998.

1999. The government injected altogether Y7,450bn (\$62bn) into the 15 biggest Japanese banks⁴³ in exchange of convertible preferential shares and bonds with different conversion terms of the banks.⁴⁴ As a result, the cumulative capital-to-assets ratio for Japan's 17 largest banks stood above 10% at the end of the fiscal year 1998.⁴⁵ Almost all Japanese banks that received government capital injection in March 1999 posted pre-tax profits in the first half of 1999 and forecast that they would post a profit for the entire fiscal year.⁴⁶ The bank consolidation waves in 1999 and 2000 are expected to further enhance Japan's banking system.⁴⁷

⁴³ The 15 banks were: Asahi Bank, Dai-Ichi Kangyo Bank, Daiwa Bank, Fuji Bank, Sakura Bank, SanwaBank, Sumitomo Bank, Tokai Bank, Chuo Trust and Banking Co., Mitsubishi Trust and Banking Corp., Mitsui Trust and Banking Co., Sumitomo Trust and Banking Co., Toyo Trust and Banking Co., the Industrial Bank of Japan, and the Bank of Yokohama. The 15 major banks submitted management improvement plans for acceptance of public funds. See, e.g., Japan Weekly Monitor, 'FRC to Keep Urging Major Banks to Promote Restructuring' (May 3, 1999), available at '1999 WL 8897362'.

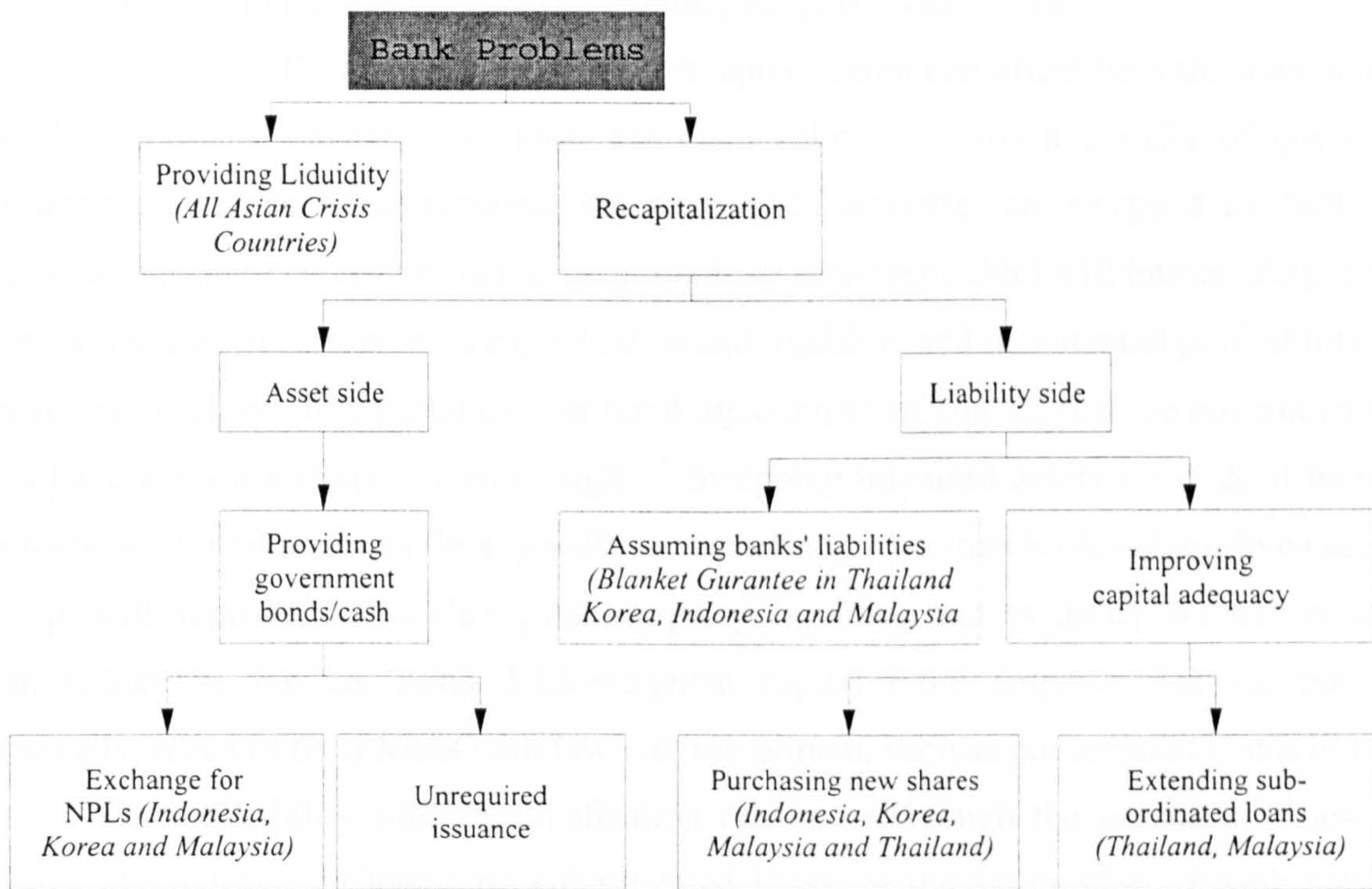
⁴⁴ See, e.g., Shimamura, Kazuhiro, 'Japanese Banks Issue Shares to Ride Out Dismal Fiscal Year', *Agence France-Presse* (March 31, 1999), available at '1999 WL 2574953'.

⁴⁵ The public funds injected into the banks offset drops in their ratios caused by the disposal of some Y10 trillion in NPLs. Besides, banks have succeeded in boosting their capital equity through their own efforts, such as third-party share allocation, and the use of cost method to calculate the value of their shareholdings. See Dow Jones International News, 'Cap Adequacy Ratio for 17 Largest Japan Bks Over 10%-Nikkei' (March 31, 1999).

⁴⁶ See Tett, Gillian, 'Improving Fortunes for Japan's Bank', *Fin. Times* (November 23, 1999); 'Japanese Banks: Profits Prompt Hope of Recovery', *Fin. Times* (November 22, 1999); and Summaries Staff, 'Japanese Banks Post Healthy Profits', *Fin. Times* (November 19, 1999). The banks posting profits include: Asahi, Dai-Ichi Kangyo, Fuji, Sakura, Sumitomo, Tokai, Industrial Bank of Japan, Bank of Tokyo Mistubishi, Sanwa Bank, Daiwa Bank, Mitsubishi Trust Bank, Sumitomo Trust, Toyo Trust, Mitsui Trust and Chuo Trust. Their profits are mainly due to the cheap cost of obtaining funds, improved management of bad loans and tight cost control. The profits strengthen the banks and thus make it easier for them to write off their bad loans. *Id.*

⁴⁷ The process of consolidation started with a declaration in the summer 1999 of a merger between the Industrial Bank of Japan, Fuji and Dai-Ichi Kangyo, and continued with the Sumitomo and Sakura deal in the autumn. These two largest mergers were followed by the February 2000 announcement of Sanwa, Asahi and Tokai, three of Japan's largest banks, to merge their operations next year. See Tett, Gillian, Nakamae, Naoko, Rahman, Bayan & Clifford, Lisa, 'Three Japanese Banks to Merge', *Fin. Times* (March 14, 2000); and Ibison, David, 'Japan's Bank Groups Launch', *Fin. Times* (April 1, 2001).

ANNEX IV: TECHNIQUES TO HELP BANKS IN DISTRESS — EXPERIENCE OF ASIAN CRISIS COUNTRIES (FROM THE GOVERNMENT’S POINT OF VIEW)



Sources: ‘Box 4 Different Kinds of Support to Banks’ in Claessens, Stijin, ‘Experiences of Resolution of Banking Crises’ in *Strengthening the Banking System in China: Issues and Experience*, BIS Policy Papers No. 7, 275, at 289 (October 1999); and also ‘Table 3. Liquidity Support Provided to Financial Institutions’, ‘Table 6. Summary of Measures to Deal with the Financial Sector Turmoil’ and ‘Table 12 Instruments Used to Recapitalize and Purchase NPLs’ in Balino, Tomas J. T., Enoch Charles *et al.*, *Financial Sector Crisis and Restructuring Lessons from Asia*, 26, 45, 61 (IMF, September 1999).

Capital Injection Vs. Liquidity Provision. Looking at the different methods governments have taken in assisting distressed banks, a distinction can be made between operations aimed at recapitalizing banks and those that provide banks with liquidity. The latter is the most common immediate response to banking problems, but it can only provide a temporary relief. During the Asian financial crisis, all the five crisis countries (Thailand, South Korean, Indonesia, Malaysia and Philippines) provided central bank liquidity support

to financial institutions to offset the withdrawal of deposits and credits at some institutions.¹ The liquidity support provides an opportunity for banks to buy unimpaired assets. This does not increase capital, however. Nor does it improve capital ratios because assets and liabilities increase by the same amount.² Moreover, the liquidity support can only be temporary. Central banks will have to sterilize the liquidity support sooner or later.³

Asset Side Vs. Liability Side. Bank recapitalization can affect both the asset side and the liability side. On the asset side, the main solution entails a transfer of government securities. This can be un-required, but more often securities are swapped for NPLs. Un-required injections of cash or bonds (negotiable or non-negotiable) will immediately increase a bank's net worth, improve its capital ratios and liquidity, and its potential profitability.⁴ The main drawback of un-required cash or bond injection is, of course, that the government does not have any ownership or control rights.⁵ Swapping impaired assets for cash or bond will usually be at market prices (less, possibly substantially less, than book value). Even so, these swaps will improve the bank's capital adequacy, liquidity, and its ability to make loans, and can reduce its funding costs. Risk-weighted capital ratios improve because the swap, generally, replaces risky loans with low-risk investment, such as government bonds or cash.⁶

On the liability side, recapitalization can occur through the purchase of new bank shares, the granting of long-term subordinated loans, or the assumption of bank liabilities. Equity purchase or subordinated loan granting by the government can immediately increase a bank's net worth, improve its capital ratios, liquidity, and its potential profitability. Liability assumption by government facilitates banks to re-negotiate its debts and obtain a breathing space. Debt renegotiation can sometimes even result in a bank's liability reduction, which improves the bank's capital-to-assets ratios and potential profitability.⁷

All the above-mentioned approaches have been employed in Asian crisis countries.⁸ In all the countries except Thailand and Philippines, centralized AMC's were established to take over NPLs from banks and other financial institutions. In Indonesia and Malaysia, bonds

¹ See Balino, Tomas J. T., Enoch Charles *et al.*, *Financial Sector Crisis and Restructuring Lessons from Asia*, 26 & table 3 (IMF, September 1999).

² See Claessens, Stijin, 'Experiences of Resolution of Banking Crises' in *Strengthening the Banking System in China: Issues and Experience*, BIS Policy Papers No. 7, 275, at 289 & Box 4 (October 1999).

³ See Balino, Tomas J. T., Enoch Charles *et al.*, *Financial Sector Crisis and Restructuring Lessons from Asia*, 27 (IMF, September 1999).

⁴ *Supra* note 2.

⁵ *Id.*

⁶ *Id.*

⁷ *Id.*

⁸ See Balino, Tomas J. T., Enoch Charles *et al.*, *supra* note 3, at 61 & table 12.

were issued to banks in exchange for their NPLs. In South Korea, the banks transferred their NPLs to KAMCO in exchange for shares in public enterprises. In Indonesia, bonds were issued to banks in exchange for equity. In South Korea, government purchased equity or preferred shares in banks by bonds or cash. The Malaysia authorities purchased convertible preferred shares or subordinated debt with bonds or cash. In Thailand, bonds were issued to banks in exchange for equity or subordinated debt.⁹ With regards to the government's assumption of bank's liability, in all the crisis countries except Philippines, blanket guarantees were provided by the government to depositors and most creditors of financial institutions that their claims would be honored: Thailand had announced the major elements of the guarantee in July 1997 which was reconfirmed under the IMF-supported program in August 1997. Korea established a full guarantee in November of that year. In Indonesia, the blanket guarantee was established as part of a IMF-supported program (January 1998), after a limited guarantee had failed to stabilize the situation. The government in Malaysia introduced a blanket guarantee in January 1998.¹⁰

⁹ Thai banks can choose to apply for Tier-1 capital support or Tier-2 capital support. Under the Tier-1 scheme, the government matches capital injected by private investors in the form of equity paid up with 10-year tradable government bonds carrying a market-related interest rate. The new government/private capital injection would have preferred status to existing shareholders. The Tier-2 scheme was set up to encourage corporate restructuring. Under this scheme, the capital injection will be provided by the government buying debentures issued by the bank with a maturity of 10 years and paid for with non-tradable government bonds with matching maturity and carrying market-related interest rates. See Balino, Tomas J. T., Enoch Charles *et al.*, *supra* note 3, at 164 & Box 5 (IMF, September 1999).

¹⁰ See Balino, Tomas J. T., Enoch Charles *et al.*, *supra* note 3, at 27-28. The blanket guarantee generally aims at (1) providing confidence in the banking system; (2) stabilizing the institutions' liability side; (3) buying time while the restructuring work is being organized and carried out; and (4) preserving the integrity of the payments system. *Id.*, at 28.

ANNEX V: A BRIEF DESCRIPTION OF CHINA'S FOUR AMCS*

Name of the AMC	Date of Establishment	Registered Capital	Main Mission	President
China Cinda AMC	April 20, 1999	RMB10bn from the MOF	To take over and manage CCB's NPLs	Zhu, Dengshan
China Dongfang (Orient) AMC	October 15, 1999	RMB10bn from the MOF (Comprising RMB6bn and US\$500m)	To take on the debts of the BOC issued before the end of 1996	Sun, Changji
China Great Wall AMC	October 18, 1999	RMB10bn from the MOF	To buy, restructure, and recover the bad debts of the ABC	Wang, Xingyi
China Huarong AMC	October 19, 1999	RMB10bn from the MOF	To handle the bad debt of the ICBC	Yang, Kai Sheng

Sources:

Cinda: Xinhua News Agency, 'China Opens First Asset Management Company' (April 21, 1999), *available at '1999 WL 7303136'*; China Daily, 'China: Firm Set up to Manage Assets' (April 21, 1999), *available at '1999 WL 5969010'*; Harding, James, 'Banking Reforms Part of China WTO Bid', *Fin. Times* (April 21, 1999). The CCB was chosen to do the pilot trial partly because of its high proportion of property loans, which are believed easier to sell, since a building is a single asset and the value can be reduced. *See, e.g., O'Neill, Mark, 'Asset Manager Launch Hailed But Buyers May not Come Running', South China Morning Post 4* (April 21, 1999).

Dongfang: Chinaonline, 'China Gets Second Asset Mgmt Co., Two More this Week' (October 18, 1999), *available at 'http://www.chinaonline.com/industry/financial/currentnews/secure/C9101508.asp'*; Agence France-Presse, 'China Steps up Number of Asset Management Companies to Manage Bad Debts' (October 16, 1999), *available at '1999 WL25125484'*; and Dickie, Mure, 'China: Government Launches Fresh Drive on Bad Loans', *Fin. Times* (October 18, 1999).

China Great Wall: Chinaonline, 'China Gets Third Asset Management Co., Another Wednesday' (October 18, 1999), *available at 'http://www.chinaonline.com/topstories/B2-99101805.asp'*; China Daily, 'China: New Company to Handle Assets' (October 19, 1999), *available at '1999 WL 17782977'*.

China Huarong: Chinaonline, 'China's Fourth Asset Management Company Ready to Roll' (October 20, 1999), *available at 'http://www.chinaonline.com/topstories/C9101903.asp'*; China Daily, 'China: Asset Company to Manage Bad ICBC Loans' (October 20, 1999), *available at '1999 WL 17782996'*; and Xinhua News Agency, 'China Wages Full War on Bad Assets of Banking Sector' (October 20, 1999), *available at '1999 WL 7308529'*.

*: In addition to these four AMCs, there are AMCs run by local government. The city of Shanghai, for example, has launched its own AMC as part of SOE reform. *See M. Dichie, 'China: Government Launches Fresh Drive on Bad Loans', Fin. Times* (October 18, 1999). The Guangdong Provincial government established Guangye AMC to manage state-owned industrial assets within the province. *See Chinaonline, 'Guangdong Guangye AMC Opens 6 Ailing Firms to Public Bidding' (March 29, 2001), available at 'http://www.chinaonline.com/topstories/010329/1/C01032204.asp'*.

ANNEX VI: CONSENSUAL MECHANISMS FOR CORPORATE DEBT RESTRUCTURING

1. Statutory Procedures: Chapter 11 of the US Bankruptcy Code

In the US, the bankruptcy law is federal law and primarily statutory law, comprising two different federal bankruptcy statutes: the Bankruptcy Act of 1898 (commonly referred to as the “Act” and applied to cases filed prior to October 1, 1979) and the Bankruptcy Reform Act of 1978 (commonly referred to as the “Bankruptcy Code” and applies to cases filed since October 1, 1979). The Bankruptcy Code was amended significantly in 1984, 1986 and 1994.¹

Chapter 11 of the US Bankruptcy Code provides a proceeding for the rehabilitation of the debtor or the liquidation or other disposition of its assets and properties consistent with the provisions of the Bankruptcy Code.² Before the primary reforms of the Bankruptcy Reform Act of 1978, business rehabilitations were covered by Chapters VIII, X, XI and XII of the 1898 Bankruptcy Act.³ They were consolidated into a single proceeding — Chapter 11 proceeding under the Bankruptcy Code.⁴

Chapter 11 procedures are especially relevant to debt restructuring because they are designed primarily to address financial restructuring rather than liquidation. They are based on the premise that the value of the firm as a going concern exceeds the value of its assets in the event of liquidation.⁵ Debtors are usually left in possession of their property,⁶ and the aim of the proceeding is to facilitate orderly workouts in three stages.⁷

¹ See Epstein, David G., *Bankruptcy and Other Debt-Creditor Laws (5th edition)* 130-1 (1995).

² See Rosen, Leonard M., *et al.*, ‘17. Approval and Confirmation of Chapter 11 Plans and Related Issues’, in *Business Loan Workout and Public Debt Restructuring 1988*, 601, at 607, Practising Law Institute Commercial Law and Practice Course Handbook Series No. 465 (1988).

³ The Bankruptcy Act of 1898 contains four separate chapters for the reorganization of businesses: Chapter VIII which dealt with railroad reorganizations; Chapter X that covered corporate reorganizations; Chapter XI for the arrangement of unsecured debts by corporations, partnerships and individuals; and Chapter XII which was available to non-corporate debtors who own encumbered real estate. See Epstein, David G., *supra* note 1, at 331.

⁴ In addition to Chapter 11, Chapter 13 is also available to certain business debtors, *i.e.*, “individuals with a regular income” and less than \$100,000 of unsecured debts and \$350,000 of secured debts. Chapter 13 is similar to Chapter 7 and Chapter 11 in that the case begins with the filing of a bankruptcy petition, Section 301. Chapter 13 is different from Chapter 7 and Chapter 11 in that only the debtor may file a Chapter 13 petition. There are no involuntary, *i.e.*, creditor-initiated Chapter 13 cases. Any debtor who files a Chapter 13 petition could instead have filed a Chapter 11 petition, however. For detailed of the Chapter 13 procedures, see ‘Chapter XVIII Chapter 13’ in Epstein, David G., *supra* note 1, at 369-384.

⁵ Chapter 11 allows debtor to continue its operation with the protection of the bankruptcy court as it attempts to scale down its operations and/or restructure its debts in the hope that ultimately the debtor, its creditors and its equity security holders will be able to cooperate and agree on a consensual plan of reorganization. See, Rosen, Leonard M., *et al.*, *supra* note 2, at 1015.

At the outset the procedures allow for an automatic standstill on debt servicing in order to provide the debtor-in-possession with a breathing space from its creditors.⁸ It is easy for a debtor to file a petition to commence a Chapter 11 case. Insolvency is not a precondition to a voluntary Chapter 11 petition. With two exceptions,⁹ any person that is eligible to file a voluntary bankruptcy petition under Chapter 7¹⁰ is also eligible to file a petition under Chapter 11. If the Chapter 11 petition has been filed by an eligible debtor, no formal adjudication is necessary. The filing of the petition operates as an “order for relief”(Section 301).

Second, the Code provides the debtor with access to working capital needed to carry out its operations. A seniority status is granted to debt contracted after the filing of the petition. The debtor can use encumbered property including cash collateral for its normal businesses. In a Chapter 11 case, the personal and real property that the debtor acquires after the filing of the Chapter 11 petition is generally protected from pre-petition liens. Section 363 empowers the debtor in possession to continue using, selling, and leasing encumbered property.¹¹ Moreover, Chapter 11 provides a number of inducements to third parties to extend credit to a debtor that has filed a Chapter 11 petition. A post-petition unsecured credit transaction in the Chapter 11 debtor’s “ordinary course of business” automatically has

⁶ The debtor remains in control the business in most Chapter 11 cases. Pre-bankruptcy management will continue to operate the business as a “debtor in possession” unless a request is made for the appointment of a trustee and the court, after notice and hearing, grants the request. *See* Epstein, David G., *supra* note 1, at 336.

⁷ A typical Chapter 11 case involves a business debtor that is attempting to continue its business operations by restructuring its financial obligations. And, the typical Chapter 11 case involves disputes among creditors as to the order and the amount of payment and disputes between creditors generally and the stockholders or other owners of the debtor as to how much if anything the owners can retain. *Id.*, at 331-2.

Bankruptcy practitioners view the Chapter 11 case as an ongoing negotiation among the interested parties, which include the debtor, equity security holders, the creditors’ committee, and secured creditors. *See* Lurey, Michael S., ‘11. Issues For Restructuring Public Debt Under Chapter 11’ in *Business Loan Workout and Public Debt Restructuring 1988*, 601, at 607, Practising Law Institute Commercial Law and Practice Course Handbook Series No. 465 (1988).

⁸ The automatic-stay provision is based on the recognition that a “grab race” for assets by the creditors is detrimental to the debtors as well as to the creditors as a group. It allows the debtors the opportunity to formulate a reorganization plan and ensures that creditors are treated equally.

⁹ The first exception is stockholders and commodity brokers: they are eligible for Chapter 7, but not Chapter 11. The second exception is railroads: railroads are eligible for Chapter 11, but not Chapter 7. *See* Epstein, David G., *supra* note 1, at 333.

¹⁰ Section 109 (b) contains two limitations on the availability of Chapter 7 relief to a debtor: (1) The debtor must be a “person,” *i.e.*, an individual, partnership, or corporations but not a sole proprietorship. (2) The debtor may not be a railroad, insurance company, or banking institution. *Id.*, at 144.

¹¹ Encumbered property that is not “cash collateral” may be used, sold, or leased in the ordinary course of business without a prior judicial determination of “adequate protection.” On “request” of the lien creditor, the court shall condition the use, sale, or lease or encumbered property so as to provide adequate protection. Cash collateral, however, may only be used if the lien holder consents, or if the court, after notice and hearing, finds that creditor’s collateral position is adequately protected and authorizes such use. *Id.*, at 339-41.

administrative expense priority over pre-petition creditors.¹² The court may, after notice and hearing, provide administrative expense priority for credit transactions that are not in the ordinary course of business.¹³ If priority over pre-petition unsecured creditors is not a sufficient inducement, the bankruptcy court may, after notice and hearing, authorize obtaining credit with: (1) priority over other administrative expenses, (2) a lien on the debtor's unencumbered property, or (3) a lien on the debtor's encumbered property.¹⁴ As the "last resort" provision, section 364 (d) provide that if the debtor is unable to otherwise obtain credit, the court may authorize the debtor to grant its post petition creditors a "super priority", *i.e.*, a lien on encumbered property that is equal or senior to existing liens.¹⁵

The final stage is the reorganization of the debtor's assets and liabilities and its operations. Chapter 11 grants the debtor a period of exclusivity to file a plan for restructuring.¹⁶ A Chapter 11 plan may alter the rights of unsecured creditors, secured creditors, and/or shareholders.¹⁷ The debtor does not have to negotiate with each creditor individually. Chapter 11 provides that a creditors' committee shall be established so that the debtor can negotiate with the committee.¹⁸ The Code discourages holdouts by a certain class of creditors, and the debtor can obtain court approval of the reorganization plans under the "cramdown" provisions.

¹² Bankruptcy Code, section 364 (a).

¹³ *Id.* section 364 (b).

¹⁴ *Id.* section 364 (c).

¹⁵ The court may authorize such a "super priority" only if there is "adequate protection" of the pre-petition secured creditor's interest, however. *See Epstein, David G., supra* note 1, at 348.

¹⁶ A Chapter 11 plan may be filed at the same time as the petition or any time thereof. Except as otherwise provided in Section 1121, the debtor has the exclusive right to file a plan for 120 days after the date of the order for relief in the Chapter 11 case (Section 1121 (b)). If the debtor files a plan during its 120-day-exclusivity-period, no other party may file a plan unless the debtor's plan is not accepted before 180 days after the Chapter 11 order for relief. (Section 1121 (c) (3)). The court may for cause reduce or increase the debtor's exclusive 120 and 180 day periods (Section 1121 (d)). *See Lurey, Michael S., supra* note 7, at 630.

It has been very common for courts to extend the exclusivity period. In larger cases, exclusivity has been extended beyond two years. *See Epstein, David G., supra* note 1, at 345.

Being the only party able to file a plan can be a very significant advantage to a debtor. So long as the debtor has exclusivity, creditors have the limited options of (1) accepting of what the debtor proposes or (2) moving to convert the case to Chapter 7 and liquidating all of the assets or (3) moving to end the debtor's exclusivity. *Id.*, at 344.

¹⁷ The plan shall divide creditors' claims into classes and treat each claim in a particular class the same, however. *Id.*, at 345-6. A chapter 11 plan does not always provide for cash payments to creditors. A plan can offer creditors the debtor's debt or equity securities rather than cash. Section 1145 (a) exempts the issuance of the debtor's securities under a Chapter 11 plan from federal and state registration requirements. A creditor's resale of a security received under a Chapter 11 is also exempt from federal and state registration requirements (Section 1145 (b)). *Id.*, at 348.

¹⁸ The Bankruptcy Code requires a meeting of creditors. Section 1102 directs the United States trustee to appoint a committee of unsecured creditors as soon as practicable after the order for relief. A pre-petition creditor's committee will be continued if it was "fairly chosen and is representative of the different kinds of claims to be represented", however. *Id.*, at 149.

Chapter 11 grants the bankruptcy court the authority to confirm the plan even if it has not received the necessary majorities. Approval of a Chapter 11 plan involves not only creditor acceptance but also court confirmation. A bankruptcy judge has the power to confirm a Chapter 11 plan that has not received the needed majorities, or not to confirm a Chapter 11 plan that has been accepted by all holders of claims and interests. Plans accepted by less than every class can be confirmed only if the additional requirements of section 1129 (b) are satisfied, *i.e.*: (1) at least one impaired¹⁹ class of claims has accepted the plan; (2) the plan does not discriminate unfairly; and (3) the plan is fair and equitable.²⁰

After confirmation of a Chapter 11 plan, the debtor's performance obligations are governed by the terms of the plan. The provisions of a confirmed Chapter 11 plan bind not only the debtor but also its creditors and shareholders "whether or not such creditor, equity security holder, or general partner has accepted the plan." In short, confirmation of a Chapter 11 plan operates as a discharge.²¹

The Chapter 11 procedures incorporate protections for creditors as well.²² Just to list a few: (1) Section 521 of the Code obligates the debtor to file a list of creditors. Section 342 requires appropriate notice of the order for relief.²³ (2) A creditors' committee will be established to consult with the trustee or debtor in possession concerning the administration of the case, to investigate the debtor's acts and financial condition, to participate in the formulation of the plan, and to request the appointment of a trustee and perform such other services as are in the interest of those represented.²⁴ The creditors' committee may also appear at various hearings as a party in interest, and file a plan in those situations where the debtor ceases to have the exclusive right to do so.²⁵ (3) The creditors can request to appoint a trustee to operate the business. A trustee is to be appointed if there is a cause (fraud, dishonesty, mismanagement, or incompetence) or if the appointment of a trustee is "in the interest of creditors, any equity security holders, and other interests of the estate." Once a trustee is appointed, the trustee has responsibility for the operation of the business and

¹⁹ The concept of "impairment" is unique to Chapter 11. Under section 1124 a class of claims or interests is impaired unless (1) the legal, equitable, and contractual rights of the holder are left "unaltered"; or (2) the only alteration of legal, equitable, or contractual rights is reversal of acceleration on default by curing the default and reinstating the debt. *Id.*, at 348.

²⁰ *Id.*, at 356.

²¹ *Id.*

²² See Lurey, Michael S., *supra* note 7, at 607.

²³ Generally, a creditor whose claim is included on a Chapter 11 debtor's list of creditors is not required to file a proof of claim, unless the claim is scheduled as disputed, contingent, or un-liquidated. Nonetheless, holders of unsecured claims often file proofs of claim in Chapter 11 cases. See Epstein, David G., *supra* note 1, at 334.

²⁴ *Id.*, at 335.

²⁵ *Id.*

formulation of the Chapter 11 plan.²⁶ In circumstances that no trustee is appointed, the court can order the appointment of an “examiner” when the appointment of an examiner is requested by a party in interest and the debtor’s non-trade, non-tax, unsecured debts exceed \$5,000,000, or “such appointment is in the interests of creditors, any equity security holders, and other interests of the estate.”²⁷ (4) With regard to the file of the plan, if a trustee is appointed, the trustee, a creditor, the creditor’s committee, and any other party in interest may file a plan. Similarly, if the debtor fails to file a plan and obtain creditor acceptances within the specified time periods, any party in interest may file a plan and more than one plans may be filed.²⁸ (5) Chapter 11 contemplates a consensual restructuring of the debtor’s financial obligations. While Chapter 11 does not require that every holder of a claim approve the plan (and indeed allows the cramming down of a plan opposed by most holders of claims), it does require that all creditors receive adequate information about a plan and have an opportunity to vote on the plan. Section 1125 requires full disclosure before post-petition solicitation of acceptances of a Chapter 11 plan. Creditors and shareholders must be provided with a copy of the plan or a summary of the plan and “a written disclosure statement approved, after notice and hearing by the court as containing adequate information.”²⁹ Both creditors and shareholders vote on Chapter 11 plans.³⁰ (6) The court will have to take into consideration the benefits of the creditor when confirm a plan. A plan accepted by every class of claims and interests must be confirmed by the bankruptcy court if the 11 enumerated requirements of section 1129 (a) are satisfied.³¹ With regards to plans accepted by less than

²⁶ *Id.*, at 336-7.

²⁷ *Id.*, at 337.

²⁸ *Id.*, at 345.

²⁹ *Id.*, at 349-50. “Adequate information” is defined in section 1125(a) as information that it is “reasonably practicable” for this debtor to provide to enable a “hypothetical reasonable investor” who is typical of the holders of the claims or interests to make an informed judgment on the plan.

³⁰ The majority needed for a class of claims to accept a plan is two-thirds in amount and more than one half in number of the allowed claims that actually voted have accepted the plan (Section 1126 (c)). A class of interests has accepted the plan when the plan has been accepted by holders of interests holding two thirds in amount of the allowed interests whose holders actually voted (Section 1126 (d)). The votes of entities whose acceptances or rejections are determined not to have been in good faith, or whose acceptances or rejections are determined not to have been solicited or procured in good faith, are excluded from the majority (Section 1126 (e)). A creditor is deemed to act in bad faith in rejecting a plan when the creditor is a competitor of the debtor and acts with the ulterior purpose of destroying or injuring the debtor in its business in order to further its own competitive business interests. Section 1126 (f) provides that a class that is not impaired under a plan, and each holder of a claim or interest of such class, are conclusively presumed to have accepted the plan. Section 1126 (g) provided that if a class is to receive nothing under the plan, it is deemed to have rejected the plan, and its vote need not be solicited.

³¹ See Epstein, David G., *supra* note 1, at 355. Most of the requirements of section 1129 (a) are easy to understand, easy to apply. The core of these requirements is to protect the interest of creditors’. Section 1129 (a) (7) creates a “best interests of creditors” test. It requires that each dissenting member of a class—even dissenting members of classes that approve the plan — receive as least as much under the plan as it would have received in

every class, the court can only confirm the plan if the Section 1128 requirements that the bankruptcy court hold a hearing on confirmation and give parties in interest notice of the hearing so that they might raise objections to confirmation are satisfied. In situations where there are more than one plans meeting the confirmation standards of section 1129, the court “shall consider the preferences of creditors and equity security holders in determining which plan to confirm.”³²

2. The London Approach and Its Application in “Asian Crisis Countries”

The London Approach is not a set of detailed rules, but a flexible framework that enables banks and other interested parties to reach well-based decisions about whether and what terms a company in financial difficulty might be allowed to survive. The non-statutory, market-led system evolved in the UK over the last two or three decades.³³ Mr. Smith Michael, the former head of the Bank of England’s Bank’s Business Finance Division, when talking about the London Approach, said — “Thanks to the London Approach, a large number of UK companies owe their continuing existence to the fact that their bankers and in some cases, bondholders and other creditors have followed its precepts in deciding the terms of a collective restructuring.”³⁴

The key features of the London approach include: (1) lenders are initially supportive and don’t rush to appoint receivers; (2) decisions about a company’s future are made on the basis of reliable information which is shared among all the parties to a workout; (3) such information provides a basis for lenders and other creditors to work together to reach a collective view on whether and how a company should be given financial support; and (4) pains is shared on an equitable basis.³⁵ These “common sense” principles, together with a number of more detailed “conventions” — for example, super priority being afforded to new

a Chapter 7 liquidation. Section 1129 (a) (9) provides special treatment for priority claims. A holder of an administrative expense claim or a claim for certain post-petition expenses in an involuntary case must be paid in cash on the effective date of the plan unless the claim holder otherwise agrees. Wages claims, claims for fringe benefits, and certain claims of consumer creditors must be paid in cash on the effective date of the plan unless the class agrees to accept deferred cash payments that have a present value equal to the amount of the claims. *Id.*, at 355-6.

³² *Id.*, at 354.

³³ For a brief introduction of the approach, see Smith, Michael, ‘The London Approach and Trading in Distressed Debt’, *Bank of England Quarterly Bulletin*, 222 (May 1996).

³⁴ *Id.*, at 223.

³⁵ *Id.*

money — have developed within the banking community to serve their financial and “reputation” interests.³⁶

The Bank of England helped the development of the London approach. In the 1970s and early 1980s, the Bank’s Business Finance Division became very closely involved in individual workouts, virtually taking the lead, for example, in suggesting possible terms for re-financings and persuading lending banks of their merits. Although the Bank became less active in 1990s, it still responded to requests to help the lenders involved in a workout agree among themselves the terms of a refinancing. The Bank was actively involved in some 160 multi-lender workouts during the early 1990s recession and has been kept informed of many others by the banks concerned.³⁷ When the Bank did involve itself, it acted as a mediator or “honest broker” to break logjams and to seek a solution that represents an acceptable compromise for those concerned.³⁸

The London approach has been widely applied in “Asian crisis countries” to promote corporate debt restructuring. In Indonesia, a framework for the voluntary restructuring of corporate debt — the Jarkta Initiative — was announced in September 1998 to complement the Indonesia Debt Restructuring Agency (INDRA) scheme and the amended bankruptcy law. The INDRA scheme provides exchange rate risk protection to private debtors who agree to restructure their extended debts, while the Jakarta Initiative provides a set of principles to guide and streamline out-of-court corporate restructuring. As of end-April 1999, 170 companies owing \$20.6bn in foreign currency debt (an estimated 28% of the total corporate external debt) had signed up with the task force in charge of managing Jakarta Initiative, although only 16 firms had reached agreements in principle and just 4 had standstill agreements.³⁹

Corporate restructuring in Korea is proceeding on two separate tracks: (1) a debt workout framework for the smaller *chaebol* and other large corporations, which follows the “London Approach” in its voluntary and extra-judicial nature; and (2) a different approach for the top five *chaebol* with heavy government involvement. The approach applying to the smaller *chaebol* and other large corporations involves establishing a Corporate Restructuring Agreement (CRA). The CRA has signed by 200 financial institutions, under which the

³⁶ *Id.*

³⁷ *Id.*

³⁸ *Id.*

³⁹ See, e.g., ‘Box A3.1. Corporate Debt Restructuring in Asia’ in the IMF, *International Capital Markets: Development, Prospects, and Key Policy Issues*, 67, at 67-8 (September 1999).

institutions agree to follow specific procedures for debt workout, including an automatic standstill on debt repayments, emergency (syndicated) loans, and to subject themselves to binding arbitration by the Corporate Restructuring Coordinating Committee (CRCC). Leading banks or groups of institutions holding more than 25% of a firm's debt can form a creditor's committee and the leading bank — assisted by a group of foreign advisors — negotiates with the debtor.⁴⁰ In all cases, arbitration by the CRCC has been available to resolve bottlenecks in the negotiations.⁴¹ By March 16, 1999, workout programs for 83 companies had been authorized by these financial institutions. Among them, 72 firms survived through workouts, confirming their management normalization plans and submitting them to their creditors-financiers.

In Malaysia, the Danaharta has been given very intensive powers in dealing with the borrowers of any loans it buys. These powers seemed to have had a significant effect on borrowers, because banks could threaten to sell their loans to Danaharta if the borrower failed to resume servicing the debt.⁴² Besides, The Amendments to Section 176 of the Companies Act in late 1998 has impetus on debt restructuring. Previously, a highly leveraged firm could seek section 176 protection against its creditors without the creditors' consent or even knowledge. After the amendment, the company applying for the protection would first have to seek the consent of creditors amounting to more than 50% of its liabilities. Arrangements would have to be formalized within a stipulated period, and creditors' rights have been greatly enhanced (with debtors facing stricter requirements in terms of disclosure and asset sales during the 60-day standstill period).⁴³ In addition to the court protected debt restructuring, a Corporate Debt Restructuring Committee (CDRC) was established to act as an informal debtor/creditor broker to achieve debt restructuring as an alternative to companies filing for bankruptcy.⁴⁴ As of end-July 1999, the committee implemented a total of 10 debt-restructuring plans.⁴⁵

⁴⁰ *Id.*, at 68.

⁴¹ See note 34 in Balino, Tomas J. T., Enoch Charles *et al.*, *Financial Sector Crisis and Restructuring Lessons from Asia*, 126 (IMF, September 1999).

⁴² *Id.*, 'Box 10. Linkage with Corporate Restructuring', at 65.

⁴³ See the IMF, *supra* note 39.

⁴⁴ See Balino, Tomas J. T., Enoch Charles *et al.*, *supra* note 41, at 137. The CDRC was set up to prevent companies from abusing the protection against creditors afforded by Section 176 of the Companies Act. The process of resolution can be initiated by either party, but once an appeal has been filed, there is a six-month moratorium on action during which credit committees will work with the affected parties to achieve a workout strategy. *Id.*, at 138.

⁴⁵ See the IMF, *supra* note 39, at 68.

In Thailand, the Corporate Debt Restructuring Advisory Committee (CDRAC) was formed by the Bank of Thailand with representatives from debtor and creditor groups, which agreed upon a framework for corporate debt restructuring based on the London Approach (the “Bangkok Approach”). The Bangkok Approach calls for creditors to agree on a standstill, and perhaps provide new money senior to existing debt, while the firm and its advisers propose a restructuring plan. The CDRAC initially targeted large debt restructuring cases but expanded its coverage to small- and medium-sized cases later. A scheme that would combine government support for recapitalization with corporate debt settlement (Tier 2 option) was also in place to encourage corporate debt restructuring. The Thailand also approved its new Bankruptcy Law in April 1998, which removed uncertainties on the degree of protection affordable to new money and the establishment of a specialized bankruptcy court. Also, creditors’ rights legislation has been amended, with a view to facilitating foreclosure on assets.⁴⁶

3. Bank-Led Restructuring

Bank-led restructuring has been common in countries like Japan⁴⁷ or Germany,⁴⁸ where each firm usually has a single bank for most of its business; and this bank will normally help resolve financial difficulties. Bank-led restructuring was developed fully in Poland.

Among transition economies, Poland was a pioneer in the bank and enterprise restructuring. The main tool it used to implement the restructuring program was the 1993 law on financial restructuring of enterprises and banks (EBRP),⁴⁹ in an approach that encouraged banks to play a central role in enterprise restructuring.

Following the end of the socialist system, Polish enterprises were confronted with serious economic problems, resulting in the emergence and recognition of a huge wave of NPLs in banks’ portfolios. For the entire banking system, about 28% of bank loans were bad

⁴⁶ *Id.*, at 69.

⁴⁷ See, e.g., Sheard, Paul, ‘Main Banks and the Governance of Financial Distress’ in Aoki, Masahiko & Patrick, Huge (eds.), *The Japanese Main Bank System*, 180-230 (1994). Sheard surveys 42 cases covering a 30-years period and finds out that the overall picture is one of the main bank coordinating, overseeing, and, in some case, taking charge of an informal reorganization of the firm. *Id.*, at 193.

⁴⁸ For a comprehensive review of the “bank-based” German system, see Edwards, Jeremy & Fischer, Klaus, *Banks, Finance and Investment in Germany* (1994); and also Baums, Theodor, ‘The German Banking System and Its Impact on Corporate Finance and Governance’, in Aoki, Masahiko & Patrick, Huge (eds.), *The Japanese Main Bank System*, 409-449 (1994).

⁴⁹ The Law of February 3, 1993 on Financial Restructuring of Enterprises and Banks. The law was in force from March 1993 to March 1996. An unofficial English translation can be found at the World Bank website.

(about 5.8% of GDP) by end-1992. Furthermore, Poland, like all transition economies, experienced a sharp increase in inter-enterprise arrears.⁵⁰ The severe distress in the banking and enterprise sectors forced Poland to tackle enterprise and bank problems simultaneously.

The enterprise problems were mainly tackled through bank interventions. In practice, the Polish strategy operated mainly through an informal out-of-court approach under which banks would keep in their books the NPLs albeit in a restructuring form.⁵¹

The 1993 law provided banks with three new tools: bank-led conciliation agreements (BCAs), the public sale of bank debts on the secondary market, and the possibility of debt-equity swaps. According to the law, BCAs were to be used mainly with debtors that were SOEs or joint stock companies in which the state held at least 50% of the shares (art. 6). BCAs could be used for a limited period of three years (March 18, 1993 to March 18, 1996) as a special mechanism for rescheduling debtors' obligations to the banks and to other creditors (art. 37).

The bank conciliation procedures were designed as a temporary process to bypass some shortcomings of Poland's existing judicial debt workout procedure — the law on "Arrangement Proceedings". The latter dated from 1934 (although significant amendments were made in 1990) and is extremely inflexible.⁵² The bank conciliation procedure shifts power from courts and borrowers to banks. Banks are empowered to negotiate workout agreements with problem debtors and force them on dissenting creditors, providing that creditors representing over 50% of the value of outstanding debt agree. A firm can apply for the procedure to its leading bank creditor, as long as that creditor holds 20% of that firm's

⁵⁰ See Fernando Montes-Negret & Papi, Luca, *The Polish Experience in Bank and Enterprise Restructuring*, 1 (The World Bank, November 1996).

⁵¹ A different approach was followed for those (often large) state-owned enterprises (SOEs) whose restructuring was assessed complex and very sensitive from a social and political point of view. For these enterprises and external approach was implemented involving the removal of their delinquent loans from the balance sheet of the originating bank to a government "resolution" agency. *Id.*, at 6.

⁵² For example, workouts under this law exclude secured creditors and government creditors (such as tax and social security offices), and thus in most cases the proceeding covers only trade creditors and bank creditors (to the extent they give up any security interests). In addition, the procedure requires only financial terms in the resulting agreement. Broader restructuring provisions, such as changes in employment, investment, or management, are not envisioned. Any agreement must be approved by a two-third majority (in terms of value of claims), or four-fifths for write-offs greater than 40%. Finally, only parties attending the proceedings are allowed to vote on the proposed agreement. It might be very difficult for a debtor with many creditors to assemble the required majority in one place for the vote. See note 25 in Gray, Cheryl W. & Holle, Arnold, *Bank-Led Restructuring in Poland (I): An Empirical Look at the Bank Conciliation Process*, 7 (World Bank, September 1996).

debt (or 10% if the amount is at least 1 billion zloty). The parties then negotiate whether to pursue this route or opt for one of the other choices provided under the EBRP.⁵³

Borrowers and/or certain creditors acquire several potential advantages if they opt for restructuring under BCAs rather than judicial conciliation.⁵⁴ First, the process is likely to be somewhat quicker and less cumbersome, because the courts are not involved except to hear an appeal against an agreement. Second, priority rules change. The state Treasury loses its super-priority.⁵⁵ Third, the ability of small creditors to block agreements is more limited because of the lower voting majority required for an agreement to be approved.⁵⁶ Fourth, responsibility for monitoring the restructuring program is explicitly delegated to the lead bank. If the lead bank does not terminate the agreement when the restructuring plan is violated, it becomes liable for any additional losses incurred by the other creditors.⁵⁷ Fifth, the range of potential outcomes is broader under bank-led conciliation.⁵⁸ Finally, if the conciliation agreement is declared void, any concessions are unwound, and the original debt claims of all creditors are reinstated. This gives the borrower and the lead bank strong incentives to develop a reasonable plan.

⁵³ *Id.*, at 7.

⁵⁴ *Id.*

⁵⁵ Unlike the court proceedings, the BCAs covered part of the enterprises' liabilities to the state, the agreements covering all receivables except social insurance, employment relations, and pension obligations. Secured creditors can choose to forego their security and become part of the process, as most indeed did — due to the virtual impossibility of collecting debts by foreclosing collateral in Poland. The social security office can and typically does negotiate a separate agreement with the problem debtor.

⁵⁶ The law stipulated that a voting majority based on outstanding debts was required to approve a BCA.

⁵⁷ Under the law, banks were required to make public announcements of the conciliation proceedings they intended to commence (art. 14). A bank or creditor initiating a BCA was also obligated to apply to the Ministry of Privatization for transformation of each SOE into a joint stock state treasury company. That provision was intended to allow creditors to convert their debt to enterprise equity and to encourage outside investors to invest in the enterprise paving the way for privatization.

In the overwhelming majority of cases, the banks took on the role of managers of the conciliation agreements, defining the terms and conditions. One of these conditions was the obligation to establish a creditors council, which generally included a representative of the Ministry of Finance, the bank, and other major creditors, and often included representatives of the relevant municipality authority. These creditor councils monitored the implementation of the enterprise recovery programs, and they were empowered to file to a court a motion for terminating the conciliation agreement. However, creditors' councils appeared to have done very little in practices. Banks played the main role in supervising the agreement. See Fernando Montes-Negret & Papi, Luca, *supra* note 50, at 8.

⁵⁸ To increase flexibility the law provided for a range of possible settlements between bank and its debtors, including rescheduling of debt repayments; reduction of interest; cessation of interest compounding; conversion of debt to equity; debt forgiveness, including interest; and extension of new loans (art. 16).

ANNEX VII: THE CONCILIATION AND REORGANIZATION PROCEDURE UNDER CHINA'S ENTERPRISE BANKRUPTCY LAW

Initiation of the Procedure: Under Chapter IV of the 1986 Enterprise Bankruptcy Law,¹ if creditors file a bankruptcy petition, the government departments in charge of the debtor may, within three months after the approval of the petition by the People's Court, apply for reorganization of the debtor.² The debtor should submit a draft conciliation agreement to the creditors' committee following the filing of the reorganization application, stipulating the term within which the debts of the enterprise are to be paid.³ When the debtor and the creditors' committee enter into a conciliation agreement, the People's Court, following its confirmation of the agreement, should issue a public notice of the agreement and suspend the bankruptcy proceedings. The conciliation agreement is effective from the day of the public notice.⁴ If no agreement can be reached between the debtor and its creditors, the people's court should issue a declaration of bankruptcy.⁵

The Administration and Effects of the Reorganization: The reorganization should be administered by the government departments in charge of the debtor. The status of the reorganization should be periodically reported to the creditors' committee.⁶ The court would supervise the progress in reorganization and the implementation of the conciliation agreement.⁷ The creditors can only ask for repayment according to the reconciliation agreement. During the period of reorganization, mortgagors or pledgors should not foreclosure unless approved by the People's Court.⁸

¹ The Law of Bankruptcy for Enterprises of the People's Republic of China (Trial Implementation), adopted by the 18th Session of the Sixth National People's Congress on December 2, 1986 and effective as of August 1, 1988 (hereinafter referred to as "the Enterprise Bankruptcy Law").

² *Id.* art.17. The government departments should submit a reorganization plan to the people's court and the creditor's meeting. Article 34, Opinions of the Supreme People's Court on Issues Concerning the Implementation of the Tentative Enterprise Bankruptcy Law (*zui gao ren min fa yuan guan yu guan che zhi xing zhong hua ren min gong he guo po chan fa ruo gan wen ti de yi jian*, which was promulgated by the Supreme People's Court in November 1991) (herein after referred to as "the Supreme Court Bankruptcy Opinions"). The reorganization plan shall includes: (1) analyses on the causes of the insolvency of the enterprise; (2) plans to adjust or replace the enterprise management; (3) analyses on the feasibility of new business projects; (4) measures to make up deficits and increase surpluses; and (5) the reorganization period (no longer than 2 years) and objectives. *Id.*

³ The Enterprise Bankruptcy Law, *supra* note 1, art. 18. The draft conciliation agreement shall describe (1) the resources to repay debts; (2) debt repayment measures; and (3) a timetable of debt repayment. The Supreme Court Bankruptcy Opinions, *supra* note 2, art. 34.

⁴ The Enterprise Bankruptcy Law, *supra* note 1, art. 19.

⁵ The Supreme Court Bankruptcy Opinions, *supra* note 2, art. 35.

⁶ The Enterprise Bankruptcy Law, *supra* note 1, art. 20.

⁷ The Supreme Court Bankruptcy Opinions, *supra* note 2, art. 36.

⁸ *Id.* art. 39.

The Termination of the Reorganization Procedure: The reorganization should be terminated, and a declaration of bankruptcy should be issued if the people's court finds that any one of the following events has occurred: (1) failure to implement the conciliation agreement; (2) further deterioration of the financial condition of the debtor, provided that there is an application from the creditors' committee for termination of the reorganization; or (3) the occurrence of one of the acts listed in article 35 of the Enterprise Bankruptcy Law,⁹ provided that it seriously impairs creditors' interests. If, through the reorganization the debtor is able to repay its debts in accordance with the terms of the conciliation agreement, the people's court would terminate the reorganization and issue a public notice thereof. If the debtor, upon the expiration of the period of time for the reorganization, cannot repay its debts in accordance with the conciliation agreement, the people's court should declare the debtor bankrupt and re-enter the claims.¹⁰

⁹ These acts are: (1) the concealment, secret distribution or gratuitous transfer of assets; (2) the sale of assets at an unusually low price; (3) the grant of security to previously unsecured creditors; (4) the repayment of immature debts; and (5) the relinquishment of claims held by the debtor. The Enterprise Bankruptcy Law, *supra* note 1, art. 35.

¹⁰ *Id.* art. 22.

ANNEX VIII: CHINA'S MAIN BANK SYSTEM

The main bank system was introduced into China in July 1996 under the Interim Measures issued by the PBOC.¹ In that year, 300 enterprises entered the pilot trial of the main bank system. The trial pilot was expanded to 500 enterprises in 1997.²

The main bank system aims at implementing principal deposit account management for large and medium enterprises. Participating banks are responsible for organizing syndicated loans to support the enterprises. Meanwhile, the main banks will participate and support enterprises' debt restructuring.

In principle, one enterprise can only have one main bank.³ Only those extremely huge enterprise conglomerates, upon approval of the PBOC, can have more than one main banks.⁴ A bank becomes the main bank of an enterprise after the signature of 'bank-enterprise cooperation agreement'.

The main bank for an enterprise is entitled to⁵ (1) be notified about the enterprise major operational and financial condition; (2) verify the enterprise's debt and deposit with other commercial banks; (3) discipline the enterprise against its breach of loan contracts and other illegitimate activities; and (4) lead and organize syndicated loans to the enterprise. The main bank should:⁶ (1) provide information and propose for the development of the enterprise; (2) make loans to the enterprise to satisfy its reasonable funding needs (subject to the large exposure limitation); (3) help the enterprise to expand its funding resources; (4) subject to the consent of the enterprise, provide information about the enterprise's production and operation, debt-equity ratio, and creditworthiness upon the request of ancillary banks; (5) help ancillary banks to collect their loans; (6) to act as the leading bank to monitor and supervise the use of syndicated loans by the enterprise, ensuring that the enterprise repay loan principal and interests according to the terms of the syndicated loan contract; and (7) inform the enterprise of the recent development in monetary and credit policies, and financial legislation.

¹ Interim Measures Governing the Main Bank System [zhuban yinhang guanli zhanxing banfa], issued by the PBOC on June 29, 1996 and effective as of July 1, 1996.

² China Daily, 'China: Businesses Undergo Reforms' (March 30, 1997).

³ The main bank can be a branch or sub-branch of a commercial bank.

⁴ Interim Measures Governing the Main Bank System, *supra* note 1, art. 11.

⁵ *Id.* art. 15.

⁶ *Id.* art. 16.

An enterprise subject to the main bank system is entitled to⁷ (1) finance most of its operations by loans from its main bank; (2) apply loans from other banks or request its main bank to co-ordinate syndicated loans when its main bank cannot satisfy its funding request; (3) request for policy suggestion from its main bank about its debt restructuring and other important investment activities; (4) enjoy financial services provided by its main bank at preferential terms; and (5) complain to the local PBOC branch or even the headquarters of the PBOC about its main bank's violation of bank-enterprise cooperation agreement. The enterprise should,⁸ (1) put most of its deposits with the main bank; (2) inform its main bank of its issuance of bonds/shares or its borrowing from its employees timely; (3) inform its main bank of its main economic activities; (4) seek opinions from its main bank on its plan to transfer enterprise asset, to apply for bankruptcy, or to carry out merger or acquisition; and (5) notify its main bank about the change of its legal representative or management personnel.

⁷ *Id.* art. 17.

⁸ *Id.* art. 18.

ANNEX IX: GENERAL PRINCIPLES FOR CORPORATE DEBT RESTRUCTURING IN THAILAND

1. To further the long-term viability of the debtor, the plan should achieve a business, rather than just a financial restructuring.
2. If the debtor's management is providing full and accurate information and participating in all creditor committee meetings, creditors should stand still for a defined (*e.g.* 60 days) and extendable period. Restructuring should not be used to hide NPLs.
3. Debt forgiveness should only be used as a last resort and only in exchange for stocks and warrants.
4. A lead creditor institution (and within it, a specified individual) must be appointed early in the restructuring process to coordinate according to defined objectives and fixed deadlines. In major multi-creditor cases, a steering committee which is of a manageable size while representative of all creditors, should be appointed.
5. Decisions should be made on information that has been independently verified.
6. Creditors' existing collateral rights must continue.
7. New credit extended on reasonable terms to help the debtor continue operations must receive priority status.
8. Lenders should seek to lower their risk (*e.g.*, through improved loan collateral), rather than to increase returns (*e.g.*, by raising interest rates).
9. Any creditor that sells his debt claim should ensure the buyer does not impede the restructuring process.
10. Creditors should take account of the impact of any action on other creditors and on potentially viable debtors.

Source: 'Table 11 General Principles for Corporate Debt Restructuring' in Hawkins, John & Turner Philip, 'Bank Restructuring in Practice: An Overview' in *Bank Restructuring in Practice*, 6, 32, BIS Policy Papers No. 6 (August 1999). Hawkins and Turner summarized the principles in accordance with *A framework for corporate debt restructuring in Thailand*, published by the Board of Trade of Thailand, the Federation of Thai Industries, the Thai Bankers' Association, the Association of Finance Companies and the Foreign Banks' Association.

ANNEX X: THE EVOLUTION OF THE PBOC AS A BANKING REGULATOR AND SUPERVISOR

The evolution of banking regulation and supervision in China is actually a history of the PBOC. In this annex, we will mainly review how the PBOC develops into a banking regulator and supervisor in China.

1. The PBOC Before 1984

Before 1984, the PBOC functioned as both the central bank of the country and a commercial bank. The Bank experienced three stages of development from 1949 to 1983.

(i) 1949-1952: *The Establishment of the PBOC*

On December 1, 1948, The PBOC was formed at Shijiazhuang in Hebei province, by merging three banks in Liberated Areas — the Bank of Northern China, the Bank of North Sea, and the Northwest Peasant Bank.¹ After the establishment of the PRC in 1949, other Liberated-Area banks were combined into the PBOC.² The PBOC continued its expansion. Under the “Resist American, Aid Korea” campaign, all the assets held by American banks in China were confiscated and put under the PBOC’s management.³ The PBOC moved its headquarters to Beijing in 1950. A four-tier-level operation was established: a national bank at the head office in Beijing, four regional banks in four administrative areas, forty sub-banks, and 1,200 branches across the country.⁴

During this period, the main functions of PBOC in financial supervision included:⁵ (1) taking over financial institutions owned or run by the Guomindang Government in mainland China; (2) abridging foreign financial institutions of their privileges and monitoring their operations; (3) administrating and guiding private-owned financial institutions,

¹ See, e.g., Wan, Timothy Haosen, *Development of Banking Law in the Great China Area: PRC and Taiwan*, 170 (1999).

² See Dong, Suping, *Issues on Socialist Financial and Banking [She Hui Zhu Yi Chai Zheng Jing Rong Wen Ti]*, 458 (1981).

³ See Wan, Timothy Haosen, *supra* note 1, at 170 and note 6.

⁴ See Lees, Francis A. & Liaw, K. Thomas, *Foreign Participation in China’s Banking and Securities Market*, 20 (1996).

⁵ See Wang, Baoqing, ‘The Enhancing Financial Supervision and Administration in China [changyin zaishou-woguo jinrong jianguan buduan jiaqiang]’, *Jinrong Shibao* 1 (October 10, 1999).

prompting public-private cooperation; (4) interdicting financial speculation so as to stabilize prices.

(ii) *1953-1978: The Mono-bank Period*

The PBOC's mono-bank standing was established through the following steps: (1) the closing of the four PBOC regional banks and granting the headquarters of the PBOC direct controls over the PBOC branches nationwide; (2) the PBOC's absorption of the People's Construction Bank of China⁶ and the taking over of the banks from the Guomindang government;⁷ and (3) the transformation of private banking industry.⁸ After these three steps, a "mono-bank" system was established in China, with the PBOC as the "mono-bank" and the rural credit cooperatives as the grass root agents of the PBOC.

During the mono-banking period, in addition to its commercial banking operations, the main functions of the PBOC included: (1) issuance of money⁹ and control of money supply; (2) internal administration and control to ensure that the PBOC branches operate in compliance with the state policies;¹⁰ (3) supervision and control over rural credit cooperatives; (4) supervision and control of financial operations of government agencies, state-operated enterprises, and collectively-owned organizations through a specified cash-management plan; and (5) supervision and control of foreign exchange.

(iii) *1979-1984: The Separation of Commercial Banking Operations from the PBOC*

⁶ The PCBC was first set up on October 1, 1954. The bank ceased to function and was transformed into the Financial Department for Construction of Infrastructure within the MOF in 1958. See Wan, Timothy Haosen, *supra* note 1, at 171-2.

⁷ *Id.* That author describes in detail on how the Bank of Communications, the Bank of China, and the agricultural banks lost their independence.

⁸ The transformation of the private banking industry happened gradually. For example, private banks and money shops in Shanghai were first combined into four federal groups in 1950, while those banks with Guomindang government owned capital were converted into state-private jointly operated banks as a result of the confiscation of shares previously owned by the Guomindang government. The four federal groups further merged into two General Administration Offices of Federated Groups during July and September 1951. On 30 November 1952, an agreement was signed among state-private jointly operated banks and two General Administration Offices of Federated Groups to form the Unified State-Private Jointly Operated Bank. Those private banking institutions that did not join the process of transformation were ordered to cease business by the end of 1952. The 14 branches of the "Unified Bank" were combined into the savings department of the local branches of the PBOC as of February 1, 1955. The head office of the bank was also combined into the Private Business Administration Bureau of the PBOC in July 1956. *Id.*, at 172-3.

⁹ The PBOC started issuing RMB as the sole legal tender of the PRC on December 1, 1948.

¹⁰ In 1954, the PBOC issued Regulations on Internal Monitoring and Supervision, establishing the administrative supervisory system. The administrative supervisory system was combined with the Party supervisory system in 1958. See Wang, Baoqing, *supra* note 5.

The economic reform initiated in 1978 created needs for financial intermediaries to transfer savings into investment. As a result, the ABC,¹¹ the CCB¹², and the BOC¹³ were granted independent status one after another from 1979 to 1983. In 1983, the State Council decided to establish the PBOC as the country's central bank and establish a new bank named the ICBC to take over the commercial banking operations from the PBOC.¹⁴ The ICBC was formally established on January 1, 1984;¹⁵ and the PBOC has served exclusively as the country's central bank since then on.

2. The PBOC After 1984

The PBOC's development after 1984 as a financial regulator and supervisor can be divided into three stages.¹⁶

(i) 1984-July 1993

A number of new commercial banks were set up during that period in addition to the "big four".¹⁷ Non-bank financial institutions emerged at that period as well.¹⁸ The prosperous financial intermediaries created the necessity for financial regulation and supervision. The

¹¹ The ABC, which focuses on deposit and lending activities in rural areas, was the first bank to be reestablished as separate bank. It was reestablished in February 1979. This move reflected the priority assigned to agriculture in the initial stage of economic reform. The bank was initially designated to take deposit and grant loans in rural areas. See Lardy, Nicholas R., *China's Unfinished Economic Revolution*, 62 (1998).

¹² In October 1979, the CCB was removed from the administrative control of the MOF and elevated to an organization subordinate directly to the State Council, placing it on the same administrative level as China's other banks. See the PBOC, *Almanac of China's Finance and Banking 1986*, II-13. In 1980, for the first time, the CCB began to accept deposits and to engage in lending to support investment projects, rather than simply acting as a pass-through for government budgetary funds. *Id.*, at II-14.

¹³ In March 1979 the State Council elevated the administrative status of the BOC by separating it from the PBOC and making it an economic entity directly subordinated to the State Council. *Id.*, at II-10.

¹⁴ See Decisions of the State Council on the PBOC's Exclusive Role as Central Bank, issued by the State Council on September 17, 1983.

¹⁵ The ICBC was established on the basis of the vast branch network of the PBOC. Upon its formal creation, the bank immediately became China's largest financial institution. See the PBOC, *supra* note 12, at III-28 and II-46.

¹⁶ The discussion in the section draws heavily from Liu, Zhangjun & Liu, Xiaoyong, 'Enhance Risk-Prevention, Promote the Off-site Surveillance System in China [jiaqiang fengxian fangfang, jiji tuijin woguo yinhangye feixianchang jianguan tixi jianshe]' in *Handbook of Off-site Surveillance for Commercial Banks [shangye yinhang feixianchang jianguan gongzhuo shuochu]* 1, at 2-3 (China Finance Press, 1999).

¹⁷ For details of the development of these new commercial banks, see Wan, Timothy Haosen, *supra* note 1, at 186-189.

¹⁸ *Id.*, at 182-186.

financial regulation and supervision during this period was mainly administrative controls over financial institutions and bore the following three characteristics:¹⁹

First, the PBOC played the role of an all-embracing financial regulator and supervisor, executing administrative controls over all financial institutions and the whole financial market. In May 1985, the PBOC established its department of bank supervision and examination.²⁰ On January 7, 1986, the State Council issued Interim Regulations on Bank Administration, granting the PBOC supervisory powers over banks and non-bank financial institutions. On April 26, 1986, the PBOC promulgated the Interim Regulations on Administration of Financial Trust and Investment Institutions pursuant to the authority delegated by the Interim Regulations on Bank Administration.²¹ All financial institutions that engage in trust and investment business are required to comply with the Interim Regulations on Administration of Financial Trust and Investment Institutions.²² On August 11, 1988, the PBOC promulgated the Regulations on the Administration of Urban Credit Cooperatives. The above-mentioned regulations made the PBOC an all-around financial regulator responsible for supervising, regulating, and inspecting financial institutions, including approving the establishment, merger, or dismantling of specialized banks and other financial organizations, subject in many case to the State Council approval.²³

Second, the PBOC focused itself on the market-entry regulation of financial institutions and the approval of their business scope, rather than on their risk-management capacity and asset quality.²⁴ The PBOC's supervision over specialized banks, for example, were limited to their business activities, aiming at their compliance with the State economic

¹⁹ See Wang Zhaoxing, 'Financial Supervision: Opportunities and Challenge [jingrong jiaguan: fazhan yu tiaozhan]', *China Finance* No. 12, 16, at 16 (1999).

²⁰ This department, known as the Examination and Supervision Department, had more than 4,700 personnel at the end of 1988. Among them only about 200 were at the level of senior economist or senior accountant with slightly more than 1,200 in the middle grades. See the World Bank, *China: Financial Sector Policies and Institutional Development*, 33, a World Bank Country Study (1990).

²¹ Article 1, Interim Regulations on Administration of Trust and Investment Institutions, issued by the PBOC on April 26, 1986.

²² *Id.* art. 2. On January 19, 2001, the PBOC issued new Regulations on Administration of Trust and Investment Companies, revealing the Interim Regulations.

²³ Articles 5, 6 & 7, Interim Regulations of the People's Republic of China on Bank Administration, issued by the State Council on January 7, 1986 (hereinafter referred to as "Interim Regulations on Bank Administration").

²⁴ For example, instead of setting limitations to restrict over-risk-taking by banks, from 1986 to 1994, an interest-sharing scheme was run by the PBOC, allowing state bank headquarters and their local lending branches to share the interest repayment as part of their own operational revenue. This gave banks a strong incentive to increase lending. See Pu Yonghao, 'Why China Won't Be Asia's Next Basket Case Economy', available at 'http://www.chinaonline.com/commentary_analysis/ac_c9041941.html'.

and financial policies; laws and regulations; and the credit, cash, foreign currency, and financial plans.²⁵

Third, the PBOC was vulnerable to interventions from other government agencies in its financial regulation and supervision. Many financial institutions were set up during this period. Those financial institutions engaged themselves in all kinds of financial businesses, some even without the approval of the PBOC, resulting in the distortion of financial market.²⁶

(ii) *July 1993-June 1996: Administrating and Policing the Financial Market*

The Focus of financial regulation and supervision for this period was investigating and punishing against financial irregularities so as to restore orders in China's financial markets. Besides, a legal framework for banking regulation and supervision started to emerge in the country.²⁷

The State Council and the PBOC issued a series of documents to restore the financial order and regulate the business scope of financial institution.²⁸ A lot of illegally established financial institutions were closed. Many financial institutions and their managers were punished for their illegal operations.²⁹ In 1995, the Central Banking Law³⁰ and the Commercial Banking Law³¹ were adopted and came into effect, providing a legal basis for China's financial regulation and supervision.³² These efforts, however, did not touch the accumulated risks within China's financial system.

²⁵ Interim Regulations on Bank Administration, *supra* note 23, arts. 12-21. *See also* Wang, Baoqing, *supra* note 5.

²⁶ *See* Wang Zhaoxing, *supra* note 19.

²⁷ *Id.*

²⁸ *See, e.g.*, Opinions of the PBOC on Enhancing Regulation and Supervision over Financial Institutions [zhongguo renmin yinhang guanyu jiaqiang jinrong jiaguan gongzhuo yijian de yijian], approved by the State Council on September 29, 1994. According to these Opinions, the establishment, alteration and termination of financial institutions must be examined and approved by the PBOC or its branches. Those financial institutions established without the approval of the PBOC or its branches must be closed or apply to the PBOC for approval.

²⁹ *See* Wang Zhaoxing, *supra* note 19.

³⁰ The Law of the People's Republic of China on the People's Bank of China [Zhonghua Renmin Gongheguo Zhong Guo Renmin Yinghang fa], adopted at the 3rd Session of the 8th NPC on March 18, 1995 and came into effect as of the same date (hereinafter referred to "the Central Banking Law").

³¹ The Law of the People's Republic of China on Commercial Banks, adopted at the 13th Session of the Standing Committee of the 8th National People's Congress on May 10, 1995, and effective as of July 1, 1995.

³² For a long period before the adoption of the Central Banking Law and Commercial Banking Law, the banking regulation and supervision was conducted on the basis of administrative regulations and rules issued by the State Council or its subordinated ministries or commissions. The adoption of the Central Banking Law and Commercial Banking Law in 1995 marks that banking regulation and supervision in China started to be carried out on a statutory basis. In addition to the Central Banking Law and the Commercial Banking Law, there are

(iii) *June 1995- Present: The Development of Prudential Regulation in China*

The 1997 Asian financial crisis educated authorities in China. On November 17-19, 1997, the Central Committee of the CCP and the State Council held the National Financial Working Conference in Beijing, calling to establish a financial system compatible to the socialist market economy and to strengthen the risk management capacity of financial institutions in about three years.³³

After the conference, the focuses of financial regulation and supervision have been shifted or are shifting in the following four aspects:³⁴ (1) from administrative controls to ensure that financial institutions comply with laws and regulations towards the prudential regulation and supervision against over-risk-taking and irregularities of financial institutions; (2) from the market-entry regulation towards a comprehensive supervision covering the market entry, operations and market exist of financial institution; (3) from the segregated supervision between local currency and foreign currency business, on-balance-sheet and off-balance-sheet business, domestic and off-shore business towards a consolidated regulation and supervision; and (4) from the sole reliance upon the on-site inspection towards the coordination between on-site inspection and off-site examination.

3. The PBOC Develops into An Exclusive Banking Regulator and Supervisor

The after-economic reform age has also witnessed the establishment of China Securities Regulatory Commission (CSRC) and China Insurance Regulatory Commission (CIRC). As a result, the PBOC develops itself from a sole and all-embracing financial regulator to an exclusive banking regulator and supervisor.

The PBOC used to be a comprehensive regulator over the national financial sector, where financial institutions operated in one of the following four sectors: banking, securities,

other legislation efforts as well. For details of the financial lawmaking practices, see Chen, Xiaoyun, 'Summarize Experiences and Strengthening Financial Lawmaking [zongjie lifa jingyan, jiaqiang jinrong lifa]', *China Finance*, No. 4, 7 (2000); and also Chen, Xiaoyun, 'History and Prospectus of China's Financial Legislative Activities [woguo jinrong fazhi jianshe de lichen yu zhanwang]', *China Finance* No. 12, 34-36, 64 (December 1998).

³³ Historical Research Unit of the Central Committee of the CCP, 'Major Events after the Third Session of the Eleventh Central Committee of the Communist Party of China (III) (zhonggong shiyijie sanzongquanhui yilei dashiji-xia)', *People's Daily (Overseas Edition)*, 3 (December 16, 1999).

³⁴ See Wang Zhaoxing, *supra* note 19; and Wang, Baoqing, *supra* note 5, at 2.

insurance, and trust and investment.³⁵ The 1995 Central Banking Law authorized the PBOC to “exercise supervision over financial institutions and their business operations to maintain the legitimate, stable and sound operation of the financial industry”³⁶ and “approve the establishment, changes, termination and the business scope of a financial institution.”³⁷

The PBOC’s role of regulating and supervising the financial industry was later redefined by the State Council. The regulation and supervision of the securities business and the insurance industry was taken from the PBOC in 1998 with State Council’s decision to make the CSRC the sole organization to supervise the country’s securities industry,³⁸ and the establishment of the CIRC to supervise the country’s insurance industry.³⁹ As a result, the PBOC,⁴⁰ the CSRC, and the CIRC carry out their respective regulatory and supervisory responsibilities in the banking, securities and insurance industries.

The tripartite financial regulatory structure is consistent with China’s separation among commercial banking, securities and insurance, simplifies the tasks of each supervisor, and facilitates more efficient supervision on each financial sector. This structure, however, also allows for regulatory arbitrage and makes consolidated supervision difficult.⁴¹

³⁵ The 1986 Interim Regulations on Banking Administration, arts. 5, 6.

³⁶ The Central Banking Law, *supra* note 30, art. 30.

³⁷ *Id.* art. 31.

³⁸ The CSRC began in 1992 as the executive branch of the State Council Securities Commission, which supervised the securities market. In 1997, the CSRC was charged with supervising the Shanghai and Shenzhen stock exchanges. In 1998, as part of the government’s effort to streamline the bureaucracy, the SCSC and the CSRC were merged as CSRC. According to a decision of the State Council in October 1998, the new CSRC enjoys ministerial rank and performs as the sole regulatory agency for the securities industry in China, responsible for overseeing securities brokerages, which were formerly supervised by the PBOC, directly administering all local securities supervisory bodies, which used to be under local governments, and undertaking the responsibilities of the SCSC. The new commission also regulates all international participation in China’s burgeoning securities sector. See Chinaonline, ‘China Approves Regulatory Body for Securities Sector’ (October 20, 1998), available at http://www.chinaonline.com/industry/fina//hive/Secure/1998/October/fn_c8102006.asp.

³⁹ On November 18, 1998, China formally established an insurance regulatory body, the China Insurance Regulatory Commission. The insurance industry was previously supervised by the PBOC. The newly established CIRC is subject directly to the State Council and fully authorized to regulate and supervise China’s insurance industry. Its responsibility includes the drafting and adoption of policies, regulations and rules about commercial insurance; supervising insurance enterprises to ensure that they operate in compliance with the law and regulation; fostering fair competition between insurance enterprises; and promoting insurance risk assessing and early warning systems, *etc.* See Tian Li, ‘The CIRC Was Established in Beijing Today (*Zhongguo Baoxian Jiandu Weiyuanhui Zai Jing Chengli*)’, *People’s Daily (Overseas Edition)* 1 (November 19, 1999); and Chinaonline, ‘China to Establish Insurance Regulatory Body’ (November 19, 1998), available at http://www.chinaonline.com/industry/fina...ive/Secure/1998/November/fn_b8111903.asp.

⁴⁰ In October 1999, what under the PBOC supervision are three policy banks, the big four, 9 joint stock commercial banks, 88 city commercial banks, more than 50,000 rural credit cooperatives, about 3100 urban credit cooperatives, and non bank-financial institutions and foreign-invested financial institutions not under the supervision of CSRC or CIRC. See Wang, Baoqing, *supra* note 5.

⁴¹ In South Korea, for example, before the Financial Supervisory Commission was put in place, commercial banks were under the direct authority of the Monetary Board (the governing body of the BOK) and the OBS. Specialized banks and NBFIs were under the authority of the MOFE, although the MOFE delegated on-site

Fortunately, this problem has already been recognized by financial regulators in China, Xia, Bin, the director of the Non-banking Financial Institutions Regulatory Department of the PBOC, was reported said that under China's current principle of maintaining segregated financial operations, supervisory departments for banking, securities and insurance should still establish frameworks for coordination and dialogue as soon as possible.⁴² In Shanghai, a joint meeting system and information sharing system of the three regulatory institutions was initiated in August 2000.⁴³ In September 2000, a nationwide joint meeting system of the PBOC, the CSRC and the CIRC was initiated.⁴⁴

examination of some NBFIs to the OBS. This lack of a unified system of supervision and regulation, together with the weak supervision performed by MOFE on NBFIs, created conditions favorable to regulatory arbitrage and high risk practices, especially among commercial banks' trust business and merchant banks. See Balino, Tomas J. T., Enoch Charles *et al.*, *Financial Sector Crisis and Restructuring Lessons from Asia*, 115 (IMF, September 1999).

⁴² See Chinaonline, 'Cross-Sector Finance Still Banned in China' (April 6, 2000), available at '<http://www.chinaonline.com/topstories/000406/2/b200040304.asp>'. The PBOC Monetary Policy Commission made the same suggestion. See Sun, Jie, 'The PBOC Monetary Policy Commission Held Its Second Quarterly Meeting for 2000 to Determine Future Monetary Policy [yanghang huobi zhengche weiyuanhui zhaokai dier jidu lihui que ding jinhou yiduan shijian houbi zhengche zhongdian]', *People's Daily (Overseas Edition)*, 1 (April 25, 2000).

⁴³ See, e.g., 'Cooperation Among the Three Financial Regulators Established in Shanghai [shanghai jianli jinrongye jianguan hezhuo zhidu]', *Peoples Daily (overseas edition)*, 3 (August 26, 2000).

⁴⁴ See 'The Three Financial Regulators Are Cooperating in Their Regulation over Financial Industries [sanda jinrong jianguan bumeng zhengqiang jianguan heli]', *People's Daily (Overseas Edition)*, 5 (September 9, 2000).

ANNEX XI: THE PBOC'S INDEPENDENCE AND AUTONOMY, THE PBOC'S ORGANIZATIONAL RESTRUCTURING, AND THE DIVISION OF FINANCIAL SUPERVISORY DUTIES BETWEEN THE PBOC HEADQUARTERS AND ITS BRANCHES

1. Enhancing the PBOC's Independence and Autonomy

(i) *Why a More Independent PBOC?*

Despite extensive debates on pros and cons of the central bank independence (CBI),¹ the tendency worldwide is that more and more independence and autonomy is granted to central banks.² Although the CBI is advocated mainly in the conduct of monetary policy, it is also essential for effective banking supervision,³ as stated by the Basle Committee in its Core Principles for Effective Banking Supervision — “An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banking organization. Each such agency should possess operational independence and adequate resources.”⁴

The 1995 Central Banking Law mandates two tasks to the PBOC: to decide and implement monetary policies so as to stabilize the value of the currency and to promote the growth of the economy, and to regulate and supervise financial institutions.⁵ In order to perform these two tasks properly, the PBOC must have operational independence so as to be free of political interruption and interference. With regard to its role as banking regulator and supervisor, the PBOC needs to have considerable autonomy *vis-à-vis* other ministerial level units under the State Council in Beijing, as well as *vis-à-vis* the provincial party and

¹ For an excellent summary of arguments for and against the CBI, see Lastra, R. M., *Central Banking and Banking Regulation*, 13-24 (1996).

² *Id.*, at 9.

³ *Id.*, at 10.

⁴ Basle Committee, *Core Principles for Effective Banking Supervision* (September 1997), principle 1.

⁵ The Law of the People's Republic of China on the People's Bank of China, adopted at the 3rd Session of the Eighth National People's Congress on March 18, 1995, effective as of the same day (hereinafter referred to as “the Central Banking Law”), arts. 2 & 3. The powers and functions of the PBOC are provided as follows: (1) to formulate and implement monetary policies; (2) to issue RMB and control its circulation; (3) to approve, supervise, and to administer financial institutions; (4) to supervise and control the financial market; (5) to promulgate ordinances and rules concerning financial administration and businesses; (6) to hold, administer, and to manage the state foreign exchange reserve and bullion reserve; (7) to act as fiscal agent for the State; (8) to maintain the normal operation of payment, clearing and settlement systems; (9) to conduct financial investigations and make forecasts; and (10) to engage in relevant international financial activities. *Id.* art. 4.

government leaders so that it can exercise effective prudential supervision over banks and other financial institutions. In particular, the central bank must have sufficient independence and political power to achieve two objectives. First, it must be able to insulate banks from demands from political leaders to extend loans to projects that do not meet commercial lending standards. Second, it must ensure that any subsidies for policy lending are financed by the budget rather than by the banking system.

(ii) *A Historic Review of the PBOC's Independence and Autonomy before the Implementation of the 1995 Central Banking Law*

Although the PBOC assumed the responsibility of a central bank as early as January 1, 1984,⁶ it remained a weak central bank in terms of relationships with ministries in Beijing and local government quite a long time afterwards.

The PBOC's lack of independence and autonomy has its historic root. After its establishment in 1949, the PBOC only remained its administrative independence through the period of the First Five-Year Plan (1953-57). From the beginning of the Great Leap Forward in 1958 through the mid-1970s, the PBOC was subordinated to the MOF, reflecting the fact that there was very little separation of banking and fiscal operations of the government during those years.⁷

It was not until 1979 that the PBOC was separated from the MOF. It remained a weak institution, however. The provincial branches of the PBOC were subordinated to local government and party officials. Provincial authorities had the power of appointment, dismissal, transfer, and promotion of personnel of banks operating within their geographic jurisdictions. This had greatly weakened the ability of the PBOC headquarters to effectively monitor its local branches.⁸ In 1988, the PBOC headquarters was formally vested with the power to appoint and remove provincial and lower-level PBOC managers.⁹ The PBOC

⁶ The State Council in September 1983 approved in principle the separation of the commercial operations from the PBOC so as to make the PBOC an exclusive central bank. See Decisions of the State Council On the PBOC's Exclusive Role as Central Bank, issued by the State Council on September 17, 1983 (hereinafter referred to as "the Decisions on the PBOC's Exclusive Role as Central Bank"). The Decisions ordered the PBOC to be restructured to perform exclusively the functions of a central bank. The PBOC was authorized to supervise and to examine the overall banking activities of specialized banks and other financial institutions.

⁷ See Lardy, Nicholas R., *China's Unfinished Economic Revolution*, 173 (1998).

⁸ See Byrd, William A., *China's Financial System: The Changing Role of Banks*, 12 (1983).

⁹ See the World Bank, *China: Financial Sector Policies and Institutional Development*, 5, A World Bank Country Study (1990).

headquarters, however, was still required to consult with the localities, which appear to have retained veto power over appointment.¹⁰

The situation improved in 1990s. In July 1993, Zhu Rongji was appointed as the PBOC governor. Zhu's position of vice premier and his forceful style gained the PBOC some autonomy that could not have been gained before. The first thing Zhu achieved immediately after his appointment was the full authority to appoint and remove the heads of the PBOC's provincial branches.¹¹ Second, in an unprecedented move, beginning in 1994 the PBOC refused to lend money to the MOF to cover the state budget deficit. Third, under Zhu's governing, the PBOC headquarters in Beijing gained full control of PBOC credit extended to financial institutions.¹²

(iii) *An Independent Central Bank Under the Central Banking Law?*

Although the PBOC obtained some *de facto* independence, it was not until the adoption of the 1995 Central Banking Law that a binding legal and institutional framework was put in place as a source for the PBOC's political legitimacy and credibility. China's Central Banking Law was "formulated for the purpose of defining the status and functions of the People's Bank of China, ensuring the correct formulation and implementation of the state monetary policy, establishing and perfecting macro control under a central bank, and strengthening the supervision and control of the financial industry."¹³ But has the Central Banking Law granted the PBOC sufficient CBI to carry out its duties?

There are two indicators to measure legal articulation of the CBI: one is organic safeguards of independence, including appointment process, terms of office, dismissal, suitability and salary, prohibitions applicable to central bank officials while in office, restrictions on central bank officials after they leave office, and liaisons with Treasury; the other is functional safeguards of independence, including limitations on lending to the public sector, conduct of monetary policy, other central bank functions, regulatory powers, financial

¹⁰ See Lardy, Nicholas R., *supra* note 7.

¹¹ *Id.*, at 174.

¹² *Id.*, 174-5. Previously, provincial and lower-level branch offices of the PBOC had discretionary power over 30% of the central bank lending to the financial system. They were thus vulnerable to importuning by local authorities to extend credit to local branches of state banks that, in turn, would be funneled to support projects sponsored by the officials. After Zhu's take-over, the headquarters of the People's Bank was able to re-centralize authorities for all PBOC lending and the allocation of credit quotas. *Id.*

¹³ The Central Banking Law, *supra* note 5, art. 1.

autonomy, decisional autonomy.¹⁴ In the rest of this section, the CBI of the PBOC is to be assessed on the basis of these two indicators.

a. Organic Safeguards of the CBI under China's Central Banking Law

The Appointment, Terms of Office, Dismissal, Suitability and Salary, Prohibitions Applicable to Central Bank Officials while in Office, and Restrictions on Central Bank Officials after They Leave Office When the central bank was established in 1983 the principal decision-making body was the bank's board of directors.¹⁵ The chair of the board was the governor of the bank.¹⁶ But its members included the presidents of the "big four" as well as a vice minister of the MOF.¹⁷ To the extent that the board was a policymaking body, the presence of representatives of these institutions appears to have been a conflict of interests and made the PBOC vulnerable to interferences from the MOF.¹⁸

The 1995 Central Banking Law abolished the board of directors. Instead, the Law provides that the PBOC governor should assume the overall responsibility and take full control of the bank, with the assistance of the deputy governors.¹⁹ With regard to the appointment, dismissal of the governor and deputy governors of the PBOC, paragraph 2, article 9 of the law reads as follows:

The person for the Governor of the PBOC shall, on the basis of nomination by the Premier of the State Council, be decided by the National People's Congress; and when the NPC is not in session, determined by the NPC Standing Committee and appointed or removed by the President of the People's Republic of China. The deputy governors of the People's Bank of China shall be appointed and removed by the Premier of the State Council.

The provision that the governor candidate nominated by the State Council must be approved by the NPC or its Standing Committee at least makes the PBOC Governor to some extent

¹⁴ See Lastra, R. M., *supra* note 1, at 27-48.

¹⁵ Interim Regulations of the People's Republic of China on Bank Administration, issued by the State Council on January 7, 1986, art. 7.

¹⁶ See the Decisions on the PBOC's Exclusive Role as Central Bank, *supra* note 6.

¹⁷ The other members of the board of directors included experts, the deputy governor of the PBOC, a vice minister of the State Planning Commission, a vice minister of the State Economic Commission, and the head of the People's Insurance Company of China. *Id.* By the late 1980s, the composition of the board was little changed except that a vice minister of the State Economic Reform Commission has replaced the vice minister of the State Economic Commission. See the World Bank, *supra* note 9.

¹⁸ See Lardy, Nicholas, R., *supra* note 7, at 175.

¹⁹ The Central Banking Law, *supra* note 5, art. 10.

responsible to the NPC and not just to the State Council.²⁰ The provisions contained in the Central Banking Law regarding the governor and deputy governors of the PBOC, however, are not sufficient to guarantee the CBI of the PBOC. First, the Central Banking Law contains no provisions on how many deputy governors the PBOC should have and the term of the PBOC governor and deputy governors. Because the Premier of the State Council has the final say on the appointment and removal of the deputy governors of the PBOC, the State Council may appoint those persons “loyal” to the government the PBOC deputy governors and dismiss those “troublemakers” whenever it thinks necessary. These appointed deputy governors, afraid of losing their positions and powers, might give in under the government pressures. Second, except the provisions that the governor, deputy governors and other staff should be diligent in carrying out their functions, refrain from abuse of power or malpractice for private interests or holding posts concurrently in any other financial institutions, enterprises, or foundations, there is no qualification requirements for the PBOC governor and deputy governors. That makes it easy for the State Council to nominate or appoint any person they like to be the governor or deputy governors of the PBOC. Last but not least, because there is no explicit restriction on central bank officials after they leave office, central bank officials in China are susceptible to “private” incentives²¹ and political influence²² during their tenure with the central bank.

Another problem with the PBOC’s institutional structure under the 1995 Central Banking Law is the provisions concerning the Monetary Policy Committee. The Central Banking Law only provides in principle that the Monetary Policy Committee should be established within the PBOC, leaving its functions, organization, and working procedure at the discretion of the State Council.²³ Because the Monetary Policy Committee is only a consulting but not a policy-making body,²⁴ however, the State Council’s absolute right in

²⁰ There is another article designed for this purpose. Article 6 of the Central Banking Law provides that the PBOC shall submit work reports to the Standing Committee of the NPC on matters concerning over the financial industry. *Id.* art. 6.

²¹ Central bank officials should be limited in their ability to pursue private employment in credit and financial institutions for a reasonable period following their term of office. These restrictions are designed to preclude their susceptibility to “private” incentives while in office. Such provisions are particularly necessary for central banks responsible for regulating the banking industry, so as to avoid the “capture” of the regulator by the regulated institutions. See Lastra, R. M., *supra* note 1, at 35.

²² Central bankers should also be temporarily ineligible to become government officials after their term in office. This limitation is aimed at avoiding or mitigating political influence during their tenure with the central bank. *Id.*

²³ The Central Banking Law, *supra* note 5, art. 11.

²⁴ Regulations on the PBOC Monetary Policy Committee [zhongguo renmin yinhang houbi zhengce weiyuanhui tiaoli], issued by the State Council on April 15, 1997.

deciding the functions, organization, and working procedure of the Monetary Committee may not have very large negative impact on the PBOC's independence in terms of banking supervision.

Liaisons with Other Government Agencies at Central or Local Levels The Central Banking Law guarantees the independence of the PBOC in relationship with the State Council and other government agencies by provisions in three aspects.

First, the Law provides that the PBOC should report to the Standing Committee of the NPC on matters concerning the monetary policies and financial regulation and supervision.²⁵ This to some extent refrains the State Council from interrupting into the PBOC's business.

Second, the Central Banking Law grants the PBOC equal status at the administrative hierarchy to the MOF and other government ministries and commissions. Accordingly, the PBOC should, "under the leadership of the State Council, independently implement monetary policies, exercise its functions and carry on its operation according to the law and be free from intervention by local governments, other administrative organs at all levels, public organizations, or individuals."²⁶ The status of the PBOC is further clarified by the Circular of the State Council General Office on the Functions, the Internal Structure, and Manning Quotas of the PBOC,²⁷ which provides that the PBOC is "a component of the State Council" and "a macro-economic controller under the leadership of the State Council to decide and implement monetary policies and to regulate and supervise the financial industry."

Third, the Law grants the PBOC overall controls over its branches and sub-branches. According to article 12 of the Central Banking Law, the PBOC should, as necessitated by the performance of its functions, establish its branches as its representative organs and exercise centralized and unified leadership and control over its branches.²⁸

Despite the progress, the PBOC is still subordinated to the State Council. Its governor and deputy governors are still nominated or appointed by the State Council. Thus, it might be safe to conclude here that the PBOC is still organically dependent on the State Council, although it has gained more dependence from other ministries at the central government level and local governments.

²⁵ The Central Banking Law, *supra* note 5, art. 6.

²⁶ *Id.* art. 7.

²⁷ The Circular on the Functions, the Internal Structure, and Manning Quotas of the PBOC [guowuyuan bangongting guanyu yingfa zhongguo renminyinghang zhineng peizhi neishejigou he renyuan bianzhi guiding the tongzhi], issued by the General Office of the State Council in June 1998.

²⁸ The Central Banking Law, *supra* note 5, art. 12.

b. Functional Safeguards of the CBI under China's Central Banking Law

Limitations on Lending to the Public Sector A prohibition or limitation on financing the public sector's deficits or monetizing public debt is a classic indication of central bank economic independence.²⁹ The Central Banking Law establishes the PBOC economic independence by prohibiting the Bank from providing the State with overdraft facilities, or directly subscribing or underwriting State bonds or other government bonds.³⁰ Article 29 of the Law further provides that the PBOC may not provide loans to local governments at all levels, or to financial institutions other than banks, or other organizations or individuals; and that the PBOC may not act as financial guarantor for any organization or individual.³¹

The PBOC, however, is obliged to provide loans to specific non-bank financial institutions if the State Council determined so.³² This creates leeway for the State Council to instruct the PBOC to lend to public or quasi-public sector.

Conduct of Monetary Policy An independent central bank should be responsible for implementing monetary policy, as well as for determining or formulating its content. This requires the freedom to use a sufficient array of market instruments, whose application is not restricted by administrative regulations or political interference.³³ The PBOC is by no means independent in conducting monetary policy, because it can only formulate and implement monetary policies under the leadership of the State Council.³⁴ Although art. 22 of the law provides a sufficient collection of market instruments that the PBOC can use to implement monetary policy,³⁵ the PBOC is required to report its decision concerning the annual supply of bank-notes, interest rates, foreign exchange rates, and other major issues specified by the State Council to the State Council for approval before implementation.³⁶

Regulatory Powers Although the PBOC can promulgate ordinances and rules concerning financial administration and business,³⁷ the PBOC is not independent in its

²⁹ See Lastra, R. M., *supra* note 1, at 38.

³⁰ The Central Banking Law, *supra* note 5, art. 28.

³¹ *Id.* art. 29.

³² *Id.*

³³ See Lastra, R. M., *supra* note 1, at 40.

³⁴ The Central Banking Law, *supra* note 5, arts. 2 & 3.

³⁵ *Id.* art. 22, which provides that the PBOC may apply monetary policy instruments such as deposit reserve requirements, the base interest rates, rediscounting windows, lending to commercial banks, and open market operation.

³⁶ *Id.* art. 5. The PBOC must report other monetary policy decisions to the State Council for record. *Id.*

³⁷ *Id.* art. 4.

regulatory powers. Article 2 of the Central Banking Law provides that the PBOC should exercise supervision and control over the financial industry under the leadership of the State Council.³⁸

Other Central Bank Functions In addition to its regulatory powers and powers concerning monetary policy, the PBOC also acts as a fiscal agent for the State.³⁹ The PBOC, however, “shall act as the fiscal agent for the State in accordance with the law and administrative decrees and regulations.”⁴⁰

Financial Autonomy The powers of the governing bodies of a central bank independent from the Treasury may be extended through the provision of financial and budgetary autonomy to the bank.⁴¹ The PBOC enjoys full financial autonomy: The PBOC is owned solely by the State with its entire paid-up capital allocated by the State.⁴² The sole state ownership cuts off the influences by other interest groups on the PBOC. Moreover, the PBOC is authorized by the Law to exercise independent control over its financial budget.⁴³

c. Conclusion: Limited Independence of the PBOC

The 1995 Central Banking Law grants some independence to the PBOC. Organically, the PBOC becomes equal to other ministries in administrative hierarchy. The PBOC local branches are no longer vulnerable to intervention from local government. Functionally, the PBOC is authorized to formulate and implement monetary policies and exercise supervision and control over the financial industry under the leadership of the State Council, free from intervention by local governments, other administrative organs at all levels, or public organizations or individuals. The PBOC enjoys full financial autonomy.

The independence and autonomy of the PBOC is limited, however. The PBOC must carry out its functions under the leadership of the State Council. Its governor and deputy governors are nominated or appointed by the State Council. Moreover, the State Council

³⁸ *Id.* art. 2.

³⁹ *Id.* art. 4.

⁴⁰ *Id.* art. 23.

⁴¹ See Lastra, R. M., *supra* note 1, at 44. In the US, the Fed enjoys full financial and budgetary autonomy. Whereas in Germany, the Bundesbank has the power to prepare and approve its own accounts. *Id.*

⁴² The Central Banking Law, *supra* note 5, art. 8.

⁴³ *Id.* art. 37. The budget of the PBOC, however, shall be incorporated into the central budget after it has been examined and verified by the financial department of the State Council and be subject to the budgetary control and supervision of the financial department of the State Council. *Id.* That casts some doubts on whether the PBOC can really exercise independent control over its financial budget.

decides the functions, organization and working procedure of its Monetary Policy Committee.

2. The PBOC Organizational Restructuring

The importance of the PBOC organizational structure can be understood in two senses. First, an efficient internal institutional structure facilitates the PBOC to exercise more efficient banking regulation and supervision. Second, the internal institutional structure of the PBOC is relevant to its relationships with other government departments, and the relationships between the PBOC and financial institutions.

After various efforts in streamlining its headquarters and restructuring its branches, by the end of 1998, a new structural system of the PBOC came into existence, with the retrenched headquarters, 9 regional branches (supported by 20 financial supervisory offices), 328 sub-branches and 1828 sub-sub-branches.⁴⁴

(i) *Streamlining the PBOC Headquarters*

The restructuring of the PBOC headquarters was implemented in July-August 1998. In addition to transferring its securities and insurance regulatory and supervisory duties to CSRC and CIRC respectively, the PBOC transferred its businesses relevant to the Asian Development Bank to the MOF,⁴⁵ and gave back the State commercial banks and policy banks the autonomy in deciding the organizational structure and manning of their headquarters.⁴⁶ These adjustments make it possible for the PBOC to concentrate its resources on prudential banking regulation and supervision.

To streamline its supervision over commercial banks and non-bank financial institutions, the PBOC underwent major reforms in its headquarters' organizational structure.⁴⁷ Two departments, the Department of Examination and Supervision, and the Foreign Financial Institution Department were closed. Instead of having different

⁴⁴ See, e.g., Jiao, Jinpu, 'New Development of China's Financial Reform [zhongguo jinrong tizhi gaige xin fazhang]', *China Finance* No. 10, 18, at 18 (1999).

⁴⁵ The PBOC had been the official representative for China in the Asian Development Bank since 1985.

⁴⁶ The big four and policy banks are only required to record with the PBOC the organizational structure and manning of their headquarters.

⁴⁷ See Dai, Xianglong, 'Opening Address' in *Strengthening the Banking System in China: Issues and Experience*, 11 at 13, BIS Policy Papers No. 7 (October, 1999).

departments in charge of different stages of supervision, the PBOC now has the Cooperative Financial Institutions Regulations Dept., Non-Banking Financial Institutions Regulation Dept., and the First and Second Depts. of Bank Regulation to supervise and oversee a financial institution from market entry, through business operation to market exit.⁴⁸ Under this structure, consolidated supervision is imposed on financial institution's RMB business and foreign currency business, on-site-inspection and off-site-examination are more coordinated, and the separation between domestic bank supervision and foreign bank branch supervision are abolished.⁴⁹

(ii) *Reshuffling the PBOC Branches*

a. Why Restructuring?

Before the reshuffle, the PBOC had a provincial branch at the capital city of each province, autonomous region or municipality directly under the Central Government. That made it easy for local governments, especially those at the provincial level to intervene into the PBOC's monetary policy operations and its financial regulation and supervision.⁵⁰ Moreover, this branching structure made the relationship between the PBOC and commercial banks the relationship of administrative subordination rather than that between the regulator and regulatees. The PBOC provincial branches supervised the financial institutions at the same administrative level (including branches of the national commercial banks within their jurisdiction), ignoring the overall situation of a financial institution.⁵¹

The reshuffle of the PBOC branches is a great step towards a more independent central bank of China. Wen, Jiabao, one of the four vice premiers of China, when speaking at the national meeting of the directors of PBOC branches on November 14, 1998, said that the reshuffle would enhance the authority of the PBOC in implementing monetary policy, the

⁴⁸ The headquarters of the PBOC comprises 16 departments: the Accounting and Finance Dept., the Cooperative Financial Institutions Regulation Dept., the Non-Banking Financial Institutions Regulation Dept., the Payment Technology Dept., the Statistics Dept., the Treaty and Law Dept., the International Dept., the First and the Second Depts. Of Bank Regulation; the Research Bureau; the Currency and Gold Bureau; the State Coffer Bureau; the Security Bureau; and the Training Center. See Chinaonline, 'PRC Ministry/Commission Profile: People's Bank of China (PBOC)', available at 'http://www.chinaonline.com/refer/ministry_profile/pbcb3.asp'.

⁴⁹ See Jiao, Jinpu, *supra* note 44.

⁵⁰ See the People's Daily Commentator, 'An Significant Reform of the PBOC Organizational System [zhongyan yinhang guanli tizhi de zhongda gaige]', *People's Daily (Overseas Edition)*, 1 (November 16, 1998).

⁵¹ See Cai, E-sheng, 'Financial Supervision in China: Framework, Methods and Current Issues' in *Strengthening the Banking System in China: Issues and Experience*, BIS Policy Papers No. 7, 169, at 169 (October 1999).

independence of the PBOC in carrying out financial regulation and supervision, and would improve the efficiency and integration of financial regulation and supervision.⁵²

b. Steps towards the Regional Branch System

In April 1993, the 3rd Plenary Session of the 14th Communist Party Congress decided that “[t]he PBOC should by all means establish regional branches as its agencies that will administer more than one province to improve national currency circulation and unified currency adjustment”. This was followed by the similar provisions in the State Council Resolution for Financial Reform in May 1993. The 1995 Central Banking Law includes in the law the idea that the PBOC should establish regional branches.⁵³ It was not until the burst of the Asian financial crisis, however, serious steps were taken to reshuffle the PBOC branches.⁵⁴ The PBOC started considering the location of its regional branches at the beginning of 1998 and finally decided to have nine regional branches.⁵⁵ On June 12, 1998, Zhu Rongji gave the green light to the PBOC’s restructuring plan. On September 19, 1998, the Politburo of the Party’s Central Committee approved the PBOC plan.⁵⁶

On November 18, 1998, Dai, Xianglong held a ribbon cutting ceremony at the first regional branch in Shanghai.⁵⁷ The rest eight regional branches opened their office in

⁵² See Shui, Ji & Shi, Mingshen, ‘The CPC Central Committee and the State Council Decide to Reform the PBOC Organizational System [zhonggong zhongyan guowuyuan zhuochu jue ding, zhongguorenminyinhang guanli tizhi shixing gaige]’, *People’s Daily (Overseas Edition)*, 1, 4 (November 16, 1998).

⁵³ The Central Banking Law, *supra* note 5, art. 12.

⁵⁴ See Chen, Jianhua, ‘The Reform of the PBOC’s Organizational Structure [gaige renhang guanli tizhi, wangshan jinrong tiaokong jianguan tixi]’, *China Finance* No. 11, 22, at 22 (November 1998). Among the 15 measures proposed to resolve problems still facing the country’s financial sector at the November 1997 National Financial Working Conference in Beijing, the first of these measures was to eliminate PBOC’s provincial branches and set up regional branches. *Id.*

⁵⁵ At the 9th NPC in March 1998, many provinces lobbied strongly to secure a regional PBOC branch. The PBOC first ruled out the possibility of establishing regional branches in the six traditional geographic regions of China (*i.e.*, northeastern, northwestern, southwestern, northern China, eastern China and south-central branches). Three guidelines were proposed to steer the process — A regional branch must already have been proved to be efficient in order to qualify as a regional bank, and the aggregate amount of financial supervision work in province would be the determining principle rather than the physical size of a branch bank. Also, it was decided that no regional branch would be opened in Beijing in order to avoid overlap, as the central bank was already located in Beijing. See Chinaonline, ‘Evolution of China’s Central Bank Regional Branch System’ (January 27, 1999), available at ‘http://www.chinaonline.com/top_stories/today_b2_99011918.html’.

⁵⁶ *Id.*

⁵⁷ See Wang, Hongyan, ‘The First Regional PBOC Branches Opened in Shanghai [shoujia kua xingzhengqv yanhang fenghang zai hu gua pai]’, *People’s Daily (Overseas Edition)*, 1 (November 19, 1998).

December 1998 (see Table 1: The PBOC's New Regional Branches). The new system started running on January 1, 1999.⁵⁸

The regional branches carry out the following duties within their respective jurisdictions:⁵⁹ (1) to exercise comprehensive supervision over the business activities of financial institutions under the authorization of the PBOC headquarters; (2) to investigate and deal with activities violating financial laws and regulations; (3) to be in charge of the personnel affairs and budget of financial supervisory offices and central sub-branches; (4) to manage the PBOC assets and deposit reserves, and carry out rediscounting, interest rate control, and other monetary policy businesses; (5) to analyze the economic and financial situation, and regional financial risks; (6) to manage foreign exchange reserves, foreign debts, and international payments; and (7) to co-ordinate central sub-branches in their businesses of coffer management, payment and settlement, cash issuance, and financial statistics.

c. The Merger of Prefectural Sub-branches and City Sub-sub-branches

Prior to 1995, the PBOC had a prefectural sub-branch set for each prefecture, overlapping with a sub-sub-branch at the capital city of each prefecture. This overlapping structure accented the administrative relationships between the PBOC and financial institutions under its supervision. Moreover, it caused waste of resources.

The PBOC started tackling the problem with its sub-branches and sub-sub-branches prior to that of the provincial branches. In the first half of 1995, the PBOC Guizhou Province Branch organized mergers between the overlapping sub-branches and sub-sub-branches as a pilot trial. The nationwide mergers started in June 1998, precluding the restructuring of the provincial branches.⁶⁰ Altogether 148 city sub-sub-branches were abolished or merged into prefecture sub-branches.⁶¹ Mergers were also organized between overlapping setting-ups at lower levels.⁶²

⁵⁸ See Xv, Xingtang, 'The PBOC New Branch System Will Start on January 1, 1999 [zhongguo renmin yanhang xin guanli tizhi 1999 nian yi yue yi ri kaishi yunxing]', *People's Daily (Overseas Edition)*, 4 (December 31, 1998).

⁵⁹ *Id.*

⁶⁰ See Chen, Jianhua, *supra* note 54, at 23.

⁶¹ See Jiao, Jinpu, *supra* note 44.

⁶² See Chen, Jianhua, *supra* note 54, at 23.

Table 1: The PBOC’s New Regional Branches

Regional Branches	Directorial Areas*	The First Regional Branch Heads and Their Previous Post
Shanghai	Shanghai, Zhejiang, Fujian	Wu, Xiangling/Director of the State Foreign Exchange Administration
Tianjin	Tianjin, Hebei, Shanxi, Inner Mongolia	Liu, Congming/Director of the PBOC Bank Supervision Department
Guangzhou	Guangdong, Guangxi, Henan	Jiang, Chaoliang/Director of the PBOC Shenzhen Branch
Nanjing	Jiangsu, Anhui	Liu, Zhaofu/Director of the PBOC Tianjin Branch
Shenyang	Liaoning, Jilin, Heilongjiang	Tan, Jingshun/Director of the PBOC’s Gansu Branch
Wuhan	Jiangxi, Hubei, Henan	Hu, Pingxi/ Director of the PBOC Fujian Branch
Xi’an	Shangxi, Gansu, Qinhai, Ningxia, Xinjiang	Ye, Yingnan/Director of the PBOC’s Heilongjiang Branch
Jinan	Shandong, Henan	Bai, Shichun/Director of the PBOC Jiangsu Branch
Chengdu	Sichuang, Guizhou, Yunnan, Tibet	Wang, Weiqiang/Shanxi the Provincial Secretary-General of the CPC

* Beijing and Chongqing are under the direct jurisdiction of the PBOC headquarters.

Sources: Chinaonline, ‘A Siginificant Reform of the PBOC Organizational System [zhongyan yinhang guanli tizhi de zhongda gaige]’, *China Finance* No. 11, 82 (November 1998); Chinaonline, ‘Evolution of China’s Central Bank Regional Branch System’ (January 27, 1999), available at ‘http://www.chinaonline.com/top_stories/today_b2_99011918.html’.

3. The PBOC Regulations on Financial Supervisory Responsibilities

The PBOC Regulations on Financial Supervisory Responsibilities⁶³ is a very important document on banking regulation and supervision. The Regulations mainly provide for the

⁶³ Zhongguo Renmin Yinhang Jinrong Jianguan Zerenzhi (zhaixing), issued by the PBOC on April 24, 1999. The PBOC started drafting the Regulations as early as the second half of 1996. In October 1998, the PBOC started revising the first draft and eventually issued the Regulation in April 1999.

division of supervisory duties between the PBOC headquarters and its branches at various levels, the qualification for supervisory personnel, the assessment and monitoring of the financial supervisors at various levels, and punishments against illegal financial institutions and illegal financial activities.⁶⁴

(i) *The Division of Supervisory Duties between the PBOC Headquarters and Its Branches at Various Levels*

The Central Banking Law provides for the relationships between the PBOC headquarters and its branches that the PBOC headquarters “shall exercise centralized and unified leadership and control over its branches.”⁶⁵ With regard to the division of supervisory duties between the PBOC headquarters and its branches, the law provides in principle that branches of the PBOC should “as authorized by the People’s Bank of China, be responsible for the supervision and control over the financial operations and for handling relevant business operations in areas under their respective jurisdiction.”⁶⁶

The Regulations divide the supervisory duties among the PBOC headquarters and its branches according to the principles of “unified supervision” and “locality”. The Regulations focus on the division of the supervisory duties between the PBOC headquarters and its regional branches, and only provide in principle the supervisory duties of its sub-branches, central sub-sub-branches, and county branches, leaving detailed provisions to the regional branches.⁶⁷

According to the regulations, the PBOC headquarters should formulate national financial supervisory policies, supervise national financial institutions and foreign-invested financial institutions, and examine and monitor the supervisory works of its branches at various levels. Given the fact that the operations of the ten new emerging commercial banks⁶⁸ are not limited within the jurisdiction of any single regional branch, to have a

⁶⁴ See generally Ma, Junqi, ‘The PBOC Will Introduce Financial Supervision Responsibility System [mingque jianguan zeren, tigao jianguan xiaoli- jianjie “zhongguo renmin yinhang jingrong jianguan zerenzhi”(zhaixiang)]’, *China Finance* No. 7, 12 (July 1999).

⁶⁵ The Central Banking Law, *supra* note 5, art. 12.

⁶⁶ *Id.*

⁶⁷ See generally Ma, Junqi, *supra* note 64, at 13.

⁶⁸ They are: BOCOM, China Everbright Bank, CITIC Industrial Bank, China Merchants Bank, Huaxia Bank, China Minsheng Banking Corporation, Hainan Development Bank, Fujian Industrial Bank, Guangdong Development Bank and Pudong Development Bank, Most of them were established in 1990s.

consolidated supervision over these banks, the Regulations provide that the headquarters of the PBOC should take the responsibility to supervise these banks.

The regional branches are authorized grand supervisory powers by the Regulations. In addition to supervise financial institutions of the same administrative level within their jurisdictions,⁶⁹ they are in charge of the day-to-day supervision of the branches of the state policy banks and the “big four”, including the qualification control of the branch managers. Moreover, they are authorized to carry out supervision over urban and rural credit cooperatives.⁷⁰

The prefecture-level sub branches are authorized to carry out supervision over financial institutions registered within its jurisdiction and the county associations of rural and urban credit cooperatives, while the sub-sub-branches at county level are authorized to exercise supervision over rural credit cooperatives.⁷¹

(ii) *The Assessment and Monitoring of the Financial Supervisors at Various Levels*

The Regulations provide for a strict assessment of the performance of individual supervisors at various levels and the system of awards and penalties. The Regulations also provide for the qualification for supervisors. Due to the lack of experience, these provisions, however, are mainly broad provisions in principle.⁷²

4. Summary

Sufficient CBI is essential for the PBOC to carry out its duties of financial regulation and supervisions. China's Central Banking Law has granted the PBOC some independence and autonomy to carry out its tasks. What the PBOC enjoys, however, is only limited independence. The PBOC must carry out its duties under the leadership of the State Council. Whether this kind of limited independence is sufficient for the PBOC to exercise properly its duties to regulate and supervise financial industry remains a question.

⁶⁹ E.g., the regional branches take full responsibility to supervise city commercial banks, although they have to get approval from the PBOC headquarters about the entrance and exit of city commercial banks. See Ma, Junqi, *supra* note 64, at 13.

⁷⁰ *Id.*

⁷¹ *Id.*

⁷² *Id.* With regard to penalties, for example, the Regulations only provide penalties against those who “don't carry out their supervisory duties according to relevant laws and regulations, or don't report the identified problems, or don't deal with the problem according to the instruction from higher-level officials.” *Id.*

The recent restructuring of the PBOC organizational structure is a great step forward. First, an efficient internal institutional structure of the PBOC facilitates the PBOC to exercise more efficient banking regulation and supervision. Second, the internal institutional structure of the PBOC is relevant to the relationships between the PBOC and government departments, and that between the PBOC and financial institutions.

To clarify the supervisory duties between the PBOC headquarters and its branches at various levels, the PBOC issued Regulations on Financial Supervisory Responsibilities in April 1999. The regulations divide the supervisory duties of the PBOC headquarters and branches according to the principles of “unified supervision” and “locality”. The Regulations also provide for the performance assessing of individual banking supervisors at various levels, including the award and penalty system. These Regulations will certainly help the PBOC to develop a more efficient banking regulatory and supervisory system.

ANNEX XII: THE DEVELOPMENT OF BANK LOAN CLASSIFICATION AND PROVISIONING SYSTEM IN CHINA

Loan classification and provisioning practices are essential to the bank credit risk management — “Such practices can significantly affect the accuracy of public financial reporting and the potential for market discipline. In addition, loan accounting treatments have a bearing on the effectiveness of supervisory approaches, including capital requirements.... Weak or inadequate loan loss provisioning practices and poor transparency are major sources of risk to individual banks and the banking system as a whole”¹ Experiences indicate that the most common cause of bank failures, by far, is poor credit quality and credit risk management.²

The Basle Core Principles for Effective Banking Supervision require that “banks establish and adhere to adequate policies, practices and procedures for evaluating the quality of assets and the adequacy of loan loss provisions and loan loss reserves”.³ In July 1999, the Basle Committee on Banking Supervision issued Sound Practices for Loan Accounting and Disclosure,⁴ in an attempt to achieve further harmonization in this critical area. In particular, the Sound Practices elaborates on certain provisions of the Core Principles, namely, principle 8, and the first two clauses of principle 21.

The Basel Committee lists out 26 rules in its Sound Practices for Loan Accounting and Disclosure, including rules on foundations for sound accountings (rules 1-3), rules on accountings for loans (loan recognition, de-recognition and measurement, rules 4-6; loan impairment recognition and measurement, rules 7-8; adequacy of the overall allowance, rule 9; income recognition, rules 10-11), rules on public disclosure (general, rule 12; public disclosure of accounting policies and practices, rules 13-14; public disclosure of credit risk

¹ Points made by Mr. William J. McDonough, Chairman of the Basle Committee and President of the Federal Reserve Bank of New York, cited in BIS Press Release, ‘Basle Committee Issues Consultative Paper on Loan Valuation, Loan Loss Provisioning and Credit Risk Disclosure’, available at ‘<http://www.bis.org/press/p981014.htm>’.

² See Beattie, Vivien A., et al., *Banks and Bad Debts: Accounting for Loan Losses in International Banking*, 1-2 (1995), where that authors show “the very close connection between bank failures and levels of provisioning against loan losses” by a brief survey of the Continental Illinois case, Bank of New England case in the US, the Johnson Matthey Bankers case in the UK, the Canadian Commercial Bank case in Canada, the Banco Espanol de Credito case in Spain and the Credit Lyonnais case in France.

³ Basle Committee on Banking Supervision, *Core Principles for Effective Banking Supervision* (September 1997), available at ‘<http://www.bis.org/publ/bdbs30a.htm>’, principle 8.

⁴ Basel Committee on Banking Supervision, *Sound Practices for Loan Accounting and Disclosure* (July 1999) (hereinafter referred to as “*Sound Practices*”). The document does not intend to cover all issues related to loan classification and provisioning. The focus of this document is on accounting and disclosure practices relating to the credit risk in loans held in the banking book.

management, rule 15; public disclosure of credit exposure, rules 16-19; public disclosure of credit quality, rules 20-24), rules on the role of supervisors (rules 25-6). It is far beyond the scope of this annex to go through all these rules, rules related to loan classification and provisioning, however, will be referred to here and there in the rest of this annex.

1. China's Former Loan Classification Systems and Their Problems

Before the economic reform, banks in China were not banks in the sense of modern economy. Because the loans were not really commercial loans, there was no need for loan classification.⁵ The situation continued in early 1980s when there appeared to have been little or no effort to classify bank loans by their quality. This was perhaps not surprising when enterprise bankruptcy was unheard of, loans routinely were rolled over, and the financial soundness of borrowers was largely unknown to lenders. It was from the late 1980s onwards that some specialized state banks began to explore approaches to classify their loans.⁶

The 1988 MOF Rules In 1988, the MOF issued Accounting Rules for Financial and Insurance Enterprises, which divide loans into "normal" (*zhengchang*), "overdue" (*yuqi*), "dead" (*daizhi*), and "irrecoverable" (*daizhang*), with the last three categories classified as NPLs. Under the Rules, irrecoverable loans are defined as any outstanding loans with more than 3-year-overdue (including 3 years) against the prescribed period (including the extension period); outstanding loans with more than 2-year-overdue (including 2 years) against the prescribed period (including the extension period) are defined as dead loans; and outstanding loans with more than 6-month-overdue (including the 6 months) against the prescribed period (including the extension period) are defined as overdue loans. Accruals on loan will continue for overdue and dead loans, but will be recorded on a separate book.

In its Interim Provisions on State Specialized Banks' Irrecoverable Loan Reserves⁷ issued in the same year, the MOF classifies further the following loans/overdue loans as irrecoverable loans: (1) any outstanding loan (overdue or not) of which both the borrower and its guarantees are bankrupt; (2) any outstanding loan of which the borrower is dead or declared missing or dead according to the General Principles of Civil Law; (3) any

⁵ See Dai, Xianglong, 'To Accomplish a Solid Base for a Modern Banking System, We must Ameliorate Loan Classification and Improve Asset Quality', *China Finance (Beijing)* No. 7, 4 (1998).

⁶ *Id.*

⁷ Interim Provisions on State Specialized Banks' Irrecoverable Loan Reserves, issued by the Ministry of Finance and effective as of January 1, 1988 (As amended in 1992) (hereinafter referred to as "the Interim Provisions on Loan Reserves").

outstanding loan of which the borrower has suffered huge losses from uninsured natural disasters, or, if the borrower is insured, the loan balance after the borrower repay part of the loan with the insurance compensation; and (4) overdue loans specifically authorized by the State Council to be written off.⁸

The 1995 PBOC Rules The PBOC promulgated General Lending Rules in 1995,⁹ in an attempt to unifying loan classification norms among Chinese banks. The PBOC follows the MOF rules in loan classification, only with minor amendments. Under the General Lending Rules,¹⁰ NPLs include overdue loans, dead loans and irrecoverable loans. The PBOC rules define irrecoverable loan exactly the same as that of the MOF rules, while stricter definition is given to overdue loans and dead loans. Loans are classified as overdue loans immediately as it is overdue.¹¹ Dead loans are defined as any outstanding loan with more than two-years' overdue (including two years) against the prescribed period (including the extension of period), or any loan and/or overdue loan with less than two-years' overdue against the prescribed period but the borrower has ceased its operations or the project construction has stopped (for project loans).¹² Moreover, to curb the pervasive practices of loan rollovers, the General Lending Rules put limitations on extending the original maturity of any loan: Short-term loans, *i.e.*, loans of one year or less than one-year duration, are not supposed to be extended for a period longer than the original duration. Medium-term loans, *i.e.*, those of one to five years duration, can be extended for a period of no more than one-half of their initial length. Long-term loans, those of more than five-year duration, cannot be extended by more than three years.¹³

Problems with the Above-mentioned Loan Classification Systems The MOF system and the PBOC system have certain symmetry with the three-tier classification systems used in some countries. It is worth noting, however that the MOF and PBOC schemes in general are far more lenient than the minimum requirements set by the Basle Committee Sound Practices.

First, they are not in conformity with the recommendation of the Basle Committee that “[a] bank should identify and recognize impairment in a loan or a collectively assessed

⁸ *Id.* art. 3.

⁹ General Lending Rules [Daikun Tongzhe], issued by the PBOC on July 28, 1996 and effective on August 1, 1996 (hereinafter referred to as the “General Lending Rules”).

¹⁰ *Id.* art. 34.

¹¹ *Id.*

¹² *Id.*

¹³ *Id.* arts. 11 & 12.

group of loans when it is probable that the bank will not be able to collect, or there is no longer reasonable assurance that the bank will collect, all amounts due according to the contractual terms of the loan agreement.”¹⁴ Both the MOF and the PBOC rules classify loans primarily on the basis of payment status rather than risk assessment — instead of classifying loans mainly according to borrowers’ financial condition and paying capacity, both rules classify loans mainly on whether they are overdue, and how long they are overdue. In other words, they focus on *ex post* management rather than on *ex ante* prevention, ignoring the fact that some loans could become subnormal before they are due for repayment.¹⁵ Moreover, unlike in developed countries, where when a bank classified any loan, it simultaneously classified the entire amount of all loans outstanding to that particular borrower,¹⁶ Chinese banks consider each loan separately. If a borrower falls behind in repayments on one loan, any other loans to the borrower would not automatically be classified until such time as they become past due. Worse, Chinese banks classify only the portion of the loan of payment that is past due. For example, if a loan requires annual repayments of principal in equal amounts over a five-year period and the borrower misses the first repayment, only the amount of the specific required repayment would be classified past due.¹⁷ If the borrower misses subsequent repayments, they would be added to the quantity of past due loans over the next four years, as the payments were missed.¹⁸

Second, the Basel Committee *Sound Practices* requires that “when a loan is identified as impaired, a bank should cease accruing interest in accordance with the terms of the contract.”¹⁹ In China, however, interests continued to accrue on overdue loans for two years. It was until January 1, 1998 that this accrual period was shortened to one year after the loan

¹⁴ *Sound Practices*, *supra* note 4.

¹⁵ See, e.g., Wang, Jun, ‘The Implication, Principle and Implementation of Loan Risk Classification’, *China Finance (Beijing)* No. 4, 11 (1998).

¹⁶ See, e.g., the World Bank, *China: Financial Sector Policies and Institutional Development*, 72, a World Bank Country Study (1990). The presumption, based on the principle of risk assessment, is that if a borrower is out of compliance with the repayment terms of one loan, the borrower likely soon will be out of compliance on all other loans as well.

¹⁷ Standard practices elsewhere, since it is based on risk assessment, would be to classify the entire loan once the first payment was overdue.

¹⁸ See Lardy, Nicholas R., *China’s Unfinished Economic Revolution*, 116-124 (1998).

¹⁹ This principle is implemented in various ways. In most countries, banks will cease reflecting in net income the accrual of interest in accordance with the original terms of the contract for impaired loans. In some countries, banks as a result of laws or regulations must accrue interest on impaired loans in accordance with the original terms of the contract in their financial statements to protect their right of repayment or comply with a prohibition against dual accounting. To eliminate the income effect of this accrual, a corresponding specific provision generally will be established with an offsetting charge to interest income. See *Sound Practices*, *supra* note 4, paragraph 29.

became overdue.²⁰ This resulted in the untrue high profits of banks and consequently high taxes and dividends paid by banks.

Last but not least, loan provisioning requirements were not set corresponding to asset quality of banks in China. The Basel Committee Sound Practices requires that a bank establish adequate specific and general allowances to absorb estimated credit losses associated with the loan portfolio.²¹ In China, there were no requirements for specific provision under the above-mentioned systems. Banks were only required to set general provisions.

2. The Introduction of the Five-level Loan Classification System into China

With the deepening of the financial reform, the above-mentioned systems became more and more out-of-date²² and were finally replaced by a five-level loan classification system. In 1993, the Price Waterhouse began to provide technical support to the PBOC on the five-level classification system under the financial aid of the World Bank.²³ The pilot trial was first carried out in the BOCOM. From 1996 on, the Department of Examination and Supervision²⁴ of the PBOC started to apply this five-level system in their inspection of foreign bank branches in China, four BOC branches, and one ICBC branch to prepare for the nationwide application of the system.²⁵

In early 1998, the PBOC issued its Guidelines for Loan Classification²⁶. In April 1998, the PBOC held a meeting of the PBOC provincial branch heads and decided to apply the five-level loan classification system nationwide. After the trial in Guangdong province, the PBOC started applying the five-level classification system in inspecting the asset quality of domestic commercial banks and rural credit cooperatives at the end of 1998.²⁷

²⁰ See Chen, Yiyuan, *Loan Risk Classification Management [Daikuan Fengxian fenglei guanli]*, 9-10 (1999).

²¹ See *Sound Practices*, *supra* note 4.

²² See Dai Xianglong, *supra* note 5.

²³ See, e.g., Wu, Changming & Gao, Jiefa, 'Issues Relating to the Five-level Loan Classification System', *China Finance (Beijing)* No. 8, 18 (1998); and Wonacott, Peter, 'China Terms for Bad Loans', *Wall Street Journal*, interactive edition (February 25, 1998).

²⁴ The Department of Examination and Supervision was established in 1985 and stopped its existence in 1998.

²⁵ See, e.g., Jiang Chaoliang, *et al.*, *Handbook for Five-level Loan Classification [daikuan wuji fenglei shucheng duben]*, 5-6 (1999).

²⁶ Guidelines for Loan Classification (for trial implementation) [daikuan fengxian fenglei zhidao yuanze (shixing)], the PBOC Document No. 151 (1998) (hereinafter referred to as "the PBOC Guidelines for Loan Classification"). The Guidelines are accompanied by an Implementing Explanation (hereinafter referred to as "the Implementing Explanation").

²⁷ See Jiang Chaoliang, *et al.*, *supra* note 25, at 1.

The new loan classification system is justified on all the shortcomings of China's former loan classification system. Second, The new loan classification system is based on borrowers' creditworthiness so that the loan quality can be identified on time. Third, the new loan classification system, because of its conformity with the international customers,²⁸ will help promote the modernization of China's banking system. Last but not least, the new system puts emphasis on the borrower's main business and cash flow so that creditor banks will pay more attention to the management of their enterprise borrowers. This will certainly help improve SOE's operation and management.²⁹

3. The New Loan Classification System — Guidelines for Loan Classification

The new loan classification system is established by the PBOC Guidelines for Loan Classification. The Guidelines apply to all loans governed by the PBOC General Lending Rules,³⁰ *i.e.*, loans held in the banking book. The Guidelines also apply directly to credit substitutes, such as stand-by L/Cs and guarantees, *etc.* Beside, the principles established by the Guidelines apply to the classification of other off-balance-sheet items.³¹

Mainly designed for commercial banks, the Guidelines can be used as minimum standards by policy banks and other financial institutions to establish their own loan classification system.³²

(i) *The Definition and Objectives of Loan Classification*

The loan classification provided by the guidelines denotes a process to classify loans on the basis of their respective risks. The objectives underlying the classification process includes: (1) to identify the true value and the risks of a loan and to find out the quality of the loan portfolio; (2) to identify problems in the process of loan issuance, management, monitoring,

²⁸ The five-level loan classification system is widely applied by authorities worldwide, including the US, the Southeast Asian countries and most of the Eastern European transitional economies. More and more countries are taking this model. The Hong Kong Monetary Authority, for example, applied the five-level classification system in 1994. See Chen, Yiyuan, *supra* note 20, at 4-5.

²⁹ See Xue, Fei & Yang, Bin, 'Press Conference on China's Financial Situation Held by the First Session of the Ninth National People's Congress (*Shidang zhengjia huobi gongyingliang, baochi guoji shouji pingheng*)', *People's Daily (Overseas Edition)*, 2 (March 9, 1998). The PBOC governor Dai Xiaolong boosted the new loan classification system in all those three aspects at the press conference.

³⁰ The PBOC Guidelines for Loan Classification, *supra* note 26, art. 27.

³¹ *Id.* art. 27.

³² *Id.* art. 29.

and collecting, so as to enhance the credit management; and (3) to help decide whether a bank has provisioned adequately to absorb estimated credit losses associated with the loan portfolio.³³

(ii) *Criteria for Loan Classification*

Chapter two of the Guidelines sets criteria for loan classification.³⁴ Loans are classified into five categories that refer to varying credit risks — namely — pass, specially mentioned, substandard, doubtful and loss, with the last three categories classified as NPLs.³⁵ The Guidelines and its accompanying Implementing Explanation define the five categories of loans and lists out their characteristics (see Table 1: Characteristics of Loans in Different Categories).

Banks are allowed to divide one loan into different categories. For example, loan to a borrower under liquidation can be divided into different categories. If the bank estimates that the bank will receive 40%-65% of its loan principal and interests from the liquidated borrower, then 35% of loan could be classified as loss assets, 25% as doubtful assets and the rest 40% as substandard assets.³⁶

The Guidelines include specific rules for the classification of restructured loans³⁷ and loans that are issued in violation of law or regulations. Accordingly, a loan that requires restructuring must at least be classified as substandard assets; and if the borrower defaults after the loan is restructured or shows difficulties in repaying the loan, the loan should at least be classified as doubtful assets.³⁸ A loan that is issued in violation of the law or regulation must at least be classified as specially mentioned assets.³⁹

³³ *Id.* art. 2.

³⁴ *Id.* art. 8.

³⁵ *Id.* art. 3.

³⁶ *Id.* sect. 2.2.

³⁷ A loan is a “restructured loan” when the loan contract has been adjusted for the borrower’s financial difficulties. The PBOC Guidelines for Loan Classification, *supra* note 26, art. 6.

³⁸ *Id.* art. 6.

³⁹ *Id.* art. 7.

PAGE/PAGES
EXCLUDED
UNDER
INSTRUCTION
FROM
UNIVERSITY

(iii) *Basic Requirements Regarding Loan Classification upon Commercial Banks*

A commercial banks is required by the Guidelines either to adopt directly the loan classification criteria set by the Guidelines, or to establish a loan classification system itself. The system developed by a bank must have clear corresponding relationships and be interchangeable with the PBOC system. Moreover, the commercial bank must file its system with the PBOC for record.⁴⁶

Loan classification system must be complemented by effective internal controls commensurate with the size, nature, and the complexity of a bank's lending operations. That include: (1) a complete set of internal rules for lending operations, (2) an efficient credit management system; (3) the separation between loan examination and loan issuance; (4) a consecutive and complete record for each loan, and (5) an efficient information system to ensure that the bank have access to the borrower's financial condition and that the high-level bank management knows about loans issued by the bank.⁴⁷

In addition, commercial banks are required to enhance the management of overdue loans, and to keep record and monitor individual loans.⁴⁸ Banks are also required to establish policies and procedures for loan restructuring,⁴⁹ collateral management and valuation,⁵⁰ and the management of guaranteed loans.⁵¹

(iv) *The Organization and Implementation of Loan Classification*

Commercial banks are required at least to carry out an overall classification of their loan portfolio every half-year. And, whenever there are uncertainties about a borrower's financial

⁴⁶ *Id.* art. 10.

⁴⁷ *Id.* art. 9. This is the requirement of Basel Committee as well, which requires that the board of directors has ultimate oversight responsibility for establishing and maintaining a system of effective internal controls that, among other things, should ensure that lending transactions are promptly recorded, loan documentation is complete, internal loan review procedures are effective and an appropriate management information system is in place. *See Sound Practices*, *supra* note 4, paragraph 24.

⁴⁸ The PBOC Guidelines for Loan Classification, *supra* note 26, art. 12.

⁴⁹ *Id.* A commercial bank must provide clearly the pre-conditions and procedures for loan restructuring, and the management of restructured loan. *Id.*

⁵⁰ *Id.* art. 13. The collateral must be marked to market. *Id.*

⁵¹ *Id.* art. 14.

condition or the borrower's ability to repay loans, including the changes in loan collateral or guarantor, loans to that borrower should be reclassified correspondingly.⁵²

Commercial banks should ensure the independence, consistency and reliability of loan classification.⁵³ To achieve this, the bank management should take responsibilities for the implementation of loan classification;⁵⁴ and trainings must be carried out to make sure that the lending personnel has sufficient knowledge to conduct the classification.⁵⁵ Besides, an internal reporting system must be established so that lending personnel can report the situation about loans and relevant borrowers to the department in charge of loan classification,⁵⁶ and that bank management knows about the loan quality and its changes.⁵⁷

The internal auditors of a bank should examine and analyze the policies and procedures for loan classification and their implementation periodically and report in writing to bank management or the board of directors.⁵⁸

(v) *Banking Supervisor's Evaluation of a Bank's Loan Classification Policies and Practices*

The PBOC guidelines provide that the PBOC should monitor the loan quality of a commercial bank in the light of the information collected through regular supervisory reporting⁵⁹ or on-site inspection.⁶⁰ According to the Guidelines, on-site inspections should be carried out once a year in principle; while stricter supervision may be imposed on those problematic banks.⁶¹ The PBOC's supervision is not limited to carrying out independently loan classification when examining the loan quality of a bank, but also includes evaluating the bank's credit policies, credit management system, criteria and procedures for loan classification, and loan classification results.⁶²

⁵² *Id.* art. 16.

⁵³ *Id.* art. 17.

⁵⁴ *Id.*

⁵⁵ *Id.* art. 18.

⁵⁶ *Id.* art. 20.

⁵⁷ *Id.* art. 19.

⁵⁸ *Id.* art. 21.

⁵⁹ Commercial banks are obliged to report information concerning loan classification to the PBOC upon request. *Id.* art. 25.

⁶⁰ *Id.* art. 22.

⁶¹ *Id.* art. 23.

⁶² *Id.* art. 24.

The Implementing Explanation provides for the procedures and methodologies the PBOC should employ in its supervision of a commercial bank's loan quality.⁶³ Accordingly, the PBOC should evaluate the loan classification system of a bank and analyze the reliability and objectivity of the bank's loan classification procedures. The PBOC should make sure that the bank's loan classification system complies with the minimum requirements set by the PBOC Guidelines and corresponds to the system provided by the PBOC Guidelines.⁶⁴ In deciding whether a bank has classified an individual loan appropriately, the PBOC shall give consideration to:⁶⁵ (1) the borrower's paying capacity,⁶⁶ (2) the borrower's repayment record,⁶⁷ (3) the borrower's willingness to repay the loan, (4) the collateral or guarantee for the loan,⁶⁸ (5) the legal documentation of the loan,⁶⁹ and (6) the credit management of the bank.⁷⁰

(vi) *NPL Provisioning*

With regard to NPL provisioning, the PBOC Guidelines has not gone any further than the Commercial Banking Law, which provides that "commercial banks shall retain a provision against NPLs and write off loan losses in pursuance of relevant state regulations."⁷¹ The PBOC Guidelines only provide in principle for NPL provisioning as well. According to the PBOC Guidelines, commercial banks should establish NPL provisioning system according to

⁶³ The Implementing Explanation, *supra* note 26, sect. 2.1. The procedures and methodologies discussed below should be followed by bank internal auditors in auditing the loan classification of their banks, as well. *Id.*

⁶⁴ *Id.* sect. 2.11.

⁶⁵ The PBOC Guidelines for Loan Classification, *supra* note 26, art. 5.

⁶⁶ The borrower's paying capacity is the core factor for loan classification. The borrower's paying capacity must be judged on various factors, including the borrower's cash flow, financial condition, and other non-financial factors that affect the borrower's paying capacity. *Id.* art. 5; and the Implementing Explanation, *supra* note 26, sect. 2.13.

⁶⁷ The repayment record is usually the starting point to classify an individual loan. The repayment record, however, cannot substitute other analyses. For example, usually a loan can be classified as normal loan if it not overdue or less than 30 days overdue. If the borrower's financial condition deteriorates, however, the loan should be classified at least as specially mentioned assets. The Implementing Explanation to the Loan Classification Guidelines, *supra* note 26, sect. 2.12.

⁶⁸ The collateral or the guarantee of a loan is the secondary debt service resources. When there is problem with the borrower's paying capacity, the marketability of the collateral and the guarantee's paying capacity and willingness is essential to the bank's ability to collect loan principal and interests. *Id.* sect 2.21.

⁶⁹ The legal documentation of the loan affects the bank's ability to collect loan as well. For example, an incomplete contract, or a contract that it not properly signed will jeopardize the bank's ability to collect loan. *Id.* sect. 2.13.

⁷⁰ Banks with poor credit management should be paid special attention to. *Id.*

⁷¹ Article 57, the Law of the People's Republic of China on Commercial Banks, adopted at the 13th Session of the Standing Committee of the 8th National People's Congress on May 10, 1995, and effective as of July 1, 1995.

prudent accounting principles.⁷² In addition to general provisions, commercial banks are required to set up special provisions on the basis of loan classification.⁷³ So far, however, no specific rules have been established.

4. The PBOC Guidelines Vs. Basel Committee Sound Practices

Compared to China's formal loan classification system, the PBOC Guidelines mark a great step closer to international standards. Although the Guidelines were issued before the Basel Committee Sound Practices for Loan Accounting and Disclosure, the Guidelines are in conformity with the Sound Practices in principle.⁷⁴ The Guidelines, however, are far behind the Sound Practices in disclosure requirements. Besides, the Guidelines have not set out detailed rules for loan provisioning.

(i) *The Guidelines Comply with the Foundations for Sound Accounting Set out by the Basel Committee*

The Basel Committee Sound Practices set out three foundations for sound accounting, *i.e.* — (1) a bank should adopt a sound system for managing credit risk;⁷⁵ (2) Judgments by management relating to the recognition and measurement of impairment should be made in accordance with documented policies and procedures that reflect such principles as consistency and prudence;⁷⁶ and (3) The selection and application of accounting policies and procedures should conform to fundamental accounting concepts.⁷⁷

The PBOC Guidelines complies with these foundations for sound accounting by requiring — (1) that commercial banks in China either adopt the Guidelines directly, or establish a system fitting their special needs on the basis of the minimum requirements set by the Guidelines; (2) that the loan classification system be complemented by effective internal controls commensurate with the size, nature, and the complexity of a bank's lending

⁷² The PBOC Guidelines for Loan Classification, *supra* note 26, art. 28.

⁷³ *Id.*

⁷⁴ Since a consultative paper of the *Sound Practices* was issued as early as in 1998. The author assumes that the PBOC drafted the Guidelines on the basis on the Basel Committee Consultative paper.

⁷⁵ *Sound Practices*, *supra* note 4, principle 1.

⁷⁶ *Id.* principle 2.

⁷⁷ *Id.* principle 3.

operations; and (3) that commercial banks ensure the independence, consistency, and the reliability of loan classification.

(ii) *The Loan Classification Criteria and Loan Classification Procedures Set Out by the Guidelines Are in Conformity with the Basel Committee Recommendation*

The new loan classification system established by the Guidelines focuses on borrowers' paying capacity, rather than whether the loan is past due or not. This is in conformity with the recommendation of the Basel Committee that "[t]he evaluation of each loan or group of related loans should be based upon the creditworthiness of the particular borrower and the creditworthiness of the group to which the borrower belongs. The focus of the assessment of impairment is the ability of the borrower to repay all amounts due according to the contractual terms of the loan agreement."⁷⁸

Other factors relevant to the assessment of the bank's ability to collect loans recommended by the Basel Committee, such as "the debtor's payment record, overall financial condition and resources, debt service capacity, financial performance, net worth and future prospects; the prospects for support from any financially responsible guarantors; the nature and degree of protection provided by the current and stabilized cash flow and value of any underlying collateral, etc.,"⁷⁹ are also included in the PBOC Guidelines.⁸⁰

To ensure that the impairment in loans is identified in a timely manner, the Basel Committee requires that "loans be reviewed for impairment in credit quality on a regular basis"⁸¹ and that "[r]ecognition of impairment should be considered whenever circumstances cause uncertainty about a borrower's ability to repay all amounts due according to the contractual terms of the loan agreement."⁸² These have been included in the Guidelines as well.⁸³

⁷⁸ *Id.* paragraph 44.

⁷⁹ *Id.*

⁸⁰ The PBOC Guidelines for Loan Classification, *supra* note 26, art. 5.

⁸¹ *Sound Practices*, *supra* note 4, paragraph 43.

⁸² *Id.* paragraph 46.

⁸³ The PBOC Guidelines for Loan Classification, *supra* note 16, art. 16. This article requires that Commercial banks should at least carry out an overall classification of their loan portfolio every six months; and whenever circumstances cause uncertainty about a borrower's financial condition or the borrower's ability to repay loans, impairment should be recognized timely.

In addition, the Guidelines require that commercial banks pay special attention to overdue loans,⁸⁴ establish policies and procedures for loan restructuring,⁸⁵ and monitor and analyze collateral⁸⁶ and guaranteed loans periodically.⁸⁷ All these are in conformity with the Basel Committee recommendation.⁸⁸

(iii) *The Guidelines Are Far behind the Sound Practices in Disclosure Requirement*

Transparency has been a key concept for the new international financial architecture. The Basel Committee has issued general recommendations about disclosures by banks in the paper titled Enhancing Bank Transparency.⁸⁹ As a minimum requirement, the Committee has identified the following four broad areas in which all banks in their annual financial reports should provide clear and concise information with respect to the credit risk in their loan portfolio: accounting policies and practices; credit risk management; credit exposures (including information about types of loans, domestic versus international loans, loans secured by collateral, and unsecured loans); and credit quality.⁹⁰

Accordingly, A bank should provide information on its accounting policies and practices in the accounting for loans and loan impairment, the methods employed to apply those policies,⁹¹ and information on the accounting policies and methods it uses to determine specific and general allowances.⁹² Disclosures on credit risk management should include information on its risk management and control policies, and practices to mitigate credit risk, such as the policies and practices for requiring collateral and guarantees, periodic review of loans and collateral, credit risk classification systems (loan grading systems), internal credit

⁸⁴ *Id.* art. 12.

⁸⁵ *Id.* A commercial bank must provide clearly the pre-conditions and procedures for loan restructuring, and the management of restructured loan. *Id.*

⁸⁶ *Id.* art. 13. The collateral must be marked to market. *Id.*

⁸⁷ *Id.* art. 14.

⁸⁸ *Sound Practices*, *supra* note 4, paragraphs 45, 47, 48 and 49.

⁸⁹ Basel Committee on Banking Supervision, *Enhancing Bank Transparency* (September 1998).

⁹⁰ *Sound Practices*, *supra* note 4, paragraph 77.

⁹¹ *Id.* principle 13. A bank should disclose information about the accounting policies, practices and methods its uses to account for loans. With regard to accounting policies and practices for loan impairment, it should disclose information about its policies for: determining how and when to recognize impairment in a loan and the basis of measurement for impaired loans: determining when loans are considered past-due for accounting and disclosure purposes (number of days in arrears where appropriate); the basis for charging off loans; accounting for recoveries; determining when to cease accruing interest on a loan; and how it recognizes income from impaired loans, including interest recognition. *Id.* paragraph 81.

⁹² *Id.* principle 14, which requires that a bank should disclose information on the accounting policies and methods it uses to determine specific and general allowance, and it should explain the key assumptions it uses.

quality reviews, and monitoring overdue credits.⁹³ With regard the disclosure on credit quality, the Basel Committee Sound Practices require that a bank disclose information about past due and impaired loans,⁹⁴ changes in credit quality during the period,⁹⁵ changes in allowance,⁹⁶ and the ceasing of interest accrual because of deterioration in credit quality.⁹⁷

In this aspect, the PBOC Guidelines are far behind the Basel Committee recommendation. The Guidelines only provide that commercial banks should disclose their loan losses and writing-off in accordance with relevant laws and regulations,⁹⁸ without setting out any detailed rules.

5. Loan Provisioning

Loan provisioning has always been an Achilles' heel with China's loan classification and provisioning system. As mentioned before, the PBOC Guidelines only provide in principle that commercial banks should set up general and special provisions. In this section, this author will first analyze the insufficient provisioning in Chinese commercial banks, especially the "big four". Afterwards, recommendation for how to establish a sound provisioning system will be made on the basis of international practices.

(i) *The Insufficient Loan Provisioning of China's Commercial Banks*

The big four began to provision for irrecoverable loan in 1988 at fixed percentages to their outstanding loans at the beginning of the year and the percentages ceil the reserves.⁹⁹ It was

⁹³ *Id.* paragraph 84.

⁹⁴ *Id.* principle 20, which requires that a bank should disclose impaired and past due loans by major categories of borrowers and the amounts of specific and general allowances established against each category. Principle 21 requires that a bank should disclose geographic information about impaired and past due loans including, if practical, the related amounts of specific and general allowances.

⁹⁵ *Id.* principle 24, which requires that a bank should disclose summary information about troubled loans that have been restructured during the year.

⁹⁶ *Id.* principle 22, which requires that a bank should disclose a reconciliation of changes in the allowance for loan impairment.

⁹⁷ *Id.* principle 23, which requires that a bank should disclose balances of loans on which the accrual of interest- in accordance with the terms of the original loan agreement- has ceased because of deterioration in credit quality.

⁹⁸ The PBOC Guidelines on Loan Accounting and Disclosure, *supra* note 26, art. 26.

⁹⁹ The percentages required were quite low then: 0.1% for working capital loans to industrial production enterprises, commercial enterprises, and construction enterprises; 0.2% for loans to agricultural sector and urban & township collective enterprises, and loans to private enterprises and individual proprietor; 0.15% for export & import loans; 0.2% for foreign exchange loans and loans for fixed assets and loans for technology updating. No reserves were allowed to provide for loans substituting budgetary grants, special-purpose loans trusted by local

from 1992 on that the ceiling was increased to 1% of the total outstanding loans at the beginning of the year.¹⁰⁰ It has been further increased to 1% of the year-end outstanding loans from 1998 on.¹⁰¹ The 1% provisions for irrecoverable loans are tax deductible. Banks with irrecoverable loans more than 1% of their year-end outstanding loans can set aside extra provisions. The extra provisions, however, are not tax deductible.¹⁰²

Information on the actual amounts set aside against NPLs by China's big four has increased somewhat in recent years but still is sparse. All available data, however, support the view that provisions for NPLs are very inadequate. The ICBC, for example reported provisions for NPLs of RMB6.173bn in 1994, an amount just under 0.5% of its loan portfolio and only 0.2% of its total assets.¹⁰³ This ratio rose to 0.70% in 1996, but decreased to 0.39% in 1997.¹⁰⁴ The situation is no better for CCB¹⁰⁵ and the ABC,¹⁰⁶ the other two of the big fours.

The conclusion is obvious. The big four must increase their loan provisions to an adequate level so as to facilitate the writing-off of bad loans and avoid the shock of NPLs. This cannot be accomplished without updating China's NPL provisioning requirements to international standards.

(ii) *General Provisions Vs. Special Provisions*

There are two types of loan provision. First there are provisions against loans that already have been classified as non-performing. In most countries regulators require banks to set aside provisions for NPLs within a very short period of time to facilitate, if eventually necessary, the complete write-off of the loans without endangering the bank's capital.

governments and authorities in charge of the enterprise, loans secured with collateral, or inter-financial-institution loans. See the Interim Provisions on Loan Reserves, *supra* note 7, arts. 5, 6 and 7.

¹⁰⁰ The ceiling for the year 1993 was set at 0.5%. Banks were required to increase their reserves 0.1% annually from the next year on until their reserves reached 1% of their total outstanding loans at the beginning of the year. See article 2, Circular Revising Interim Provisions on State Specialized Banks' Irrecoverable Loan Reserves, issued by the Ministry of Finance and effective as of January 1, 1992.

¹⁰¹ See Circular of the Ministry of Finance on the Non-Accrual Loans and Loan Loss Provisions, *Chengshi Jinrong Bao* (July 21 1998).

¹⁰² See Gu, Yu, 'On Improving China's Irrecoverable Loan Provisioning System [dui gaijing woguo daizhang zhunbeijing zhidu de shikao]', *Journal of Finance* No. 1, 66, at 67 (1999).

¹⁰³ *Almanac of China's Finance and Banking 1995*, 517.

¹⁰⁴ See, Lardy, Nicholas R., 'The Challenge of Bank Restructuring in China' in *Strengthening the Banking System in China: Issues and Experience*, BIS Policy Papers No.7, 23 (October 1999).

¹⁰⁵ See Table 3-6 in Lardy, Nicholas R., *supra* note 18, at 98; and Lardy, Nicholas R., *supra* note 104.

¹⁰⁶ See Table 3-7 in Lardy, Nicholas R., *supra* note 17, at 99; and Lardy, Nicholas R., *supra* note 104.

Second, there are general loan loss provisions that are not ascribed to particular assets.¹⁰⁷ The mix between the two varies across countries reflecting national legislation and the nature of the loan book.

In some countries,¹⁰⁸ attention is mainly given to the procedure of determining an appropriate size of overall loan loss provisions. The main question is whether the level of loan loss provisions is sufficient to cover probable losses associated with the total loan portfolio. In these countries, all or the bulk of a bank's provisions are general provisions and identifiable losses are charged off at an early stage.¹⁰⁹ In other countries, the focus is primarily on the procedure to arrive at the net book value of individual loans with the principal question being one of whether specific provisions are sufficient to cover all ascertained and expected losses inherent in those loans on an item-by-item basis. In these countries, identified but not yet finally determined losses are often recognized through specific provisions while these losses would have been written off in the first set of countries. As a second step, banks in some of these latter countries establish additional general provisions to cover latent losses which are not yet identified but which are known to exist.¹¹⁰

The Basel Committee Sound Practices have no bias in favor of either of the two models. According to the Sound Practices, when latent losses are known to exist, but they cannot yet be ascribed to individual loans, general allowances should be established.¹¹¹ General allowances are not a substitute for the establishment of adequate specific allowances or the recording of appropriate charge-offs, however.¹¹² Instead, general allowances should be considered to represent an interim step pending the identification of losses on individual loans that are impaired. As soon as adequate information is available to identify losses on

¹⁰⁷ The Basel Committee uses the terms "general allowances" and "specific allowances" in its *Sound Practices for Loan Accounting and Disclosure*. The Committee defines a "special allowance" as an allowance that is established against a loss that is identified in an individual loan; and defines a "general allowance" as an allowance that is established for latent losses that are known to exist, but cannot yet be ascribed to individual loans. See *Sound Practices*, *supra* note 4.

¹⁰⁸ The US is a typical representative. Under SFAS 5 *Accounting for Contingencies* (FASB, 1975) a loss accrual (writing off) should be made when it is probable that an asset has been impaired or a liability has been incurred and that the amount of the loss can be reasonably estimated. While the US Banking Circular 201 (US Comptroller of the Currency, 1992) clarifies that the provision need only cover inherent losses — that is, unconfirmed losses that probably exist in the loan portfolio based upon currently available information. See Beattie, Vivien A., *et al.*, *supra* note 2, at 20-1.

¹⁰⁹ *Sound Practices*, *supra* note 4, paragraph 40.

¹¹⁰ *Id.* paragraph 41.

¹¹¹ General allowances include allowances against impairment that has been determined to be present in a group or pool of loans that share common identifiable characteristics. In some countries, general allowances are also established against the portfolio based on an analysis of its various components, including a review of all significant loans on an individual basis. *Id.* paragraph 55.

¹¹² *Id.*

individual impaired loans, the general allowances should be replaced by specific allowances (or charge-off).¹¹³

The PBOC Guidelines seems to choose the model applied by the second set of countries. Under the Guidelines, commercial banks must set up special provisions on the basis of loan classification result, in addition to general provisions.¹¹⁴ Compared to China's former system, the distinction between general and special provisions is a great step forward.

(iii) *Banks' Discretion to Provision for and to Write off Loan Loss*

The Basle Committee Sound Practices require that (1) the loan impairment should be recognized by reducing the carrying amount of the loan(s) through an allowance¹¹⁵ or charge-off¹¹⁶ and charging the income statement in the period in which the impairment occurs;¹¹⁷ and (2) the aggregate amount of specific and general allowances¹¹⁸ should be adequate to absorb estimated credit losses associated with the loan portfolio.¹¹⁹

Under China's former classification system, banks did not have the discretion to decide how many provisions they should set aside. Nor did they have the discretion to write off loan losses. The MOF set a uniform percentage for the big four. The restriction on loan loss writing-off has been even stricter. Before 1988 the big four were not allowed to write off any bad loans without specific approval from the State Council.¹²⁰ Since 1988, the big four are allowed to write off NPLs only with the approval of the PBOC or the State Council — provincial PBOC branches had the authority to approve write-offs of up to RMB50000; writing-off over RMB100,000 would need the specific approval of the State Council.¹²¹

¹¹³ *Id.* paragraph 56.

¹¹⁴ The PBOC Guidelines for Loan Classification, *supra* note 26, art. 28.

¹¹⁵ The term allowance used by Basel Committee here denotes the amount that reduces the recorded investment in a loan or a group of loans to the carrying amount on the balance sheet. Allowances are sometimes referred to as provisions or valuation reserves. It should be noted that some accountants consider the use of the terms "provision" and "reserve" inappropriate when referring to accumulate value adjustments of loan assets. In this thesis, the three concepts are exchangeable, though the author will mainly use the term "provision", while use the term allowance only when refers to Basel Committee document.

¹¹⁶ A "charge-off" (or write-off) reduces the recorded investment in the loan and, if allowances previously have been established, the amount of allowances. A charge-off is made when all or part of a loan is deemed uncollectible or there is otherwise no realistic prospect of recovery.

¹¹⁷ *Sound Practices*, *supra* note 4, principle 7.

¹¹⁸ A "specific allowance" is an allowance that is established against a loss that is identified in an individual loan. A "general allowance" is an allowance that is established for latent losses that are known to exist, but cannot yet be ascribed to individual loans.

¹¹⁹ *Sound Practices*, *supra* note 4, principle 9.

¹²⁰ See, Lardy, Nicholas R., *China's Unfinished Economic Reform*, 118 (1998).

¹²¹ See the World Bank, *supra* note 16, at 4-95.

Since 1992, the PBOC's authority to approve loan writing-off have been raised to half billion yuan. But larger amounts still require approval of the State Council.¹²² These restrictions on loan provisioning and writing off resulted in inadequate loan provisioning and delay in NPL writing off.

The PBOC Guidelines and the MOF 1998 rules grant banks discretion to set aside provisions.¹²³ But the restriction on NPL writing-off has not been changed. To bring Chinese practices closer to international standards, banks should be granted discretion to write off NPLs as well.

(iv) *Taxation and Loan Loss Provisioning*

The way in which a bank provision for or write off loan loss is, at least partly, determined by the tax system of the country where the bank operates and/or is resident. Tax potentially affects the cash flows of a bank, its earnings and hence its capital. For example, if an increase in a provision is tax deductible, then there is a reduction in the amount of tax payable by a bank; while under a tax system where write-offs are tax-deductible but increases in provisions are not deductible, managers may write off debts in preference to making a provision against them.¹²⁴ It is therefore important that tax treatments do not discourage timely and adequate loan loss provisioning or writing-off.¹²⁵

Unlike in industrialized countries,¹²⁶ tax incentives have not been provided in China to encourage banks to set aside provisions or write off loan losses. Under the MOF 1998 rules, banks are allowed to set aside extra provisions if irrecoverable loans exceed 1% of their year-end outstanding loans. The extra provisions, however, are not tax deductible. That actually discourages banks from fully provisioning for their irrecoverable loans.

6. Summary

¹²² For the detailed provisions about the writing-off application and approval procedures, see arts. 8 and 9 in the Interim Provisions on Loan Reserves, *supra* note 7.

¹²³ The PBOC Guidelines for Loan Classification, *supra* note 26, art. 28. That article provides in principle that commercial banks should establish NPL provisioning system according to prudent accounting principles.

¹²⁴ See Beattie, Vivien A, *et al.*, *supra* note 2, at 27.

¹²⁵ *Sound Practices*, *supra* note 4, paragraph 9.

¹²⁶ For example, most countries that are members of the Basle Committee grant tax deductibility to specific allowances or charge-offs in the year they occur. See *Sound Practices*, *supra* note 4, paragraph 9; and 'Table 7.2 Comparative Table of National Accounting, Taxation and Capital Adequacy Regulations' in Beattie, Vivien A, *et al.*, *supra* note 2, at 74.

The importance of loan classification and provisioning system has been evidenced fully by both Chinese and foreign experience. The Basel Committee published Sound Practices for Loan Accounting and Disclosure in July 1999 to provides guidance to banks and supervisory agencies on sound loan accounting and disclosure practices.

China's former loan classification and provisioning system was by no means in consistency with international practices. Efforts were made as early as 1993 to introduce the five-level loan classification system into China. It was not until the burst of Asian financial crisis that the authorities in China made up their mind to replace the former system with the risk-based five-level classification system, however. The PBOC issued Guidelines for Loan Classification in 1998, introducing the new system to Chinese banks. The new system started to apply nationwide at the end of 1998.

The new system under the PBOC Guidelines complies with the Basel Committee Sound Practices in the requirements for loan classification. The Guidelines, however, is far behind the Sound Practices in requirements for public disclosure. Besides, no detailed rules have been set by the PBOC Guidelines on loan provisioning. Moreover, the Guidelines keep silent on the problem of the income recognition. Banking regulators in China will have to think about these issues and try to find appropriate solution.

PAGE/PAGES
EXCLUDED
UNDER
INSTRUCTION
FROM
UNIVERSITY

ANNEX XIV: THE DEVELOPMENT OF THE BOARD OF SUPERVISORS IN STATE COMMERCIAL BANKS

The board of supervisors for State commercial banks is first provided by article 18 of the 1995 Commercial Banking Law.¹ The law also provides in principle the constituents of a board of supervisors and its duties.² On November 12, 1997, the PBOC, under the approval of the State Council, issued Interim Provisions on the Board of Supervisors for Solely State-Owned Commercial Banks.³ The 1997 interim provisions gave the PBOC almost unlimited powers in appointing members of the board of supervisors.⁴ Under the provisions, the board of supervisors was responsible to the PBOC and should report periodically to the PBOC about its works.⁵ Moreover, the PBOC paid for the running of the board of supervisor.⁶ All these blurred the nature of the board of supervisors.⁷

On March 15, 2000, the State Council promulgated the Interim Regulations on the Board of Supervisors for State-owned Key Financial Institutions, which repealed the 1997 Interim Provisions on the Board of Supervisors.⁸ The Interim Regulations set out new regulations for the board of supervisors in state-owned policy banks, commercial banks, financial asset management companies, securities firms, and insurance companies.⁹ According to the Interim Regulations, members of a board of supervisors should be appointed by the State Council and be responsible to the State Council, and to exercise

¹ The Law of the People's Republic of China on Commercial Banks, adopted at the 13th Session of the Standing Committee of the 8th National People's Congress on May 10, 1995, and effective as of July 1, 1995, art. 18.

² *Id.*

³ Interim Provisions on the Board of Supervisors for Solely State-owned Commercial Banks [guoyou duzi shangye yinhang jianshihui zhanxing guiding], approved by the State Council on October 20, 1997 and issued by the PBOC on November 12, 1997 [hereinafter referred to as the Interim Provisions on the Board of Supervisors].

⁴ Under the interim provisions on the board of supervisors, the PBOC had one representative in the board of supervisor (art. 5), detailed qualifications for supervisor were provided by the PBOC (art. 6), representatives named by other government agencies and expert supervisors were subject to the qualification examination of the PBOC (art. 7). Moreover, the PBOC could recommended the chairperson for the board of supervisor, subject to the approval of the State Council (art. 8).

⁵ The Interim Provisions on the Board of Supervisors, art. 4.

⁶ *Id.* art. 20.

⁷ The board of supervisors should represent the benefits of the state as the owner of the banks, rather than being an agent of the PBOC as banking regulator and supervisor.

⁸ Xinhua News Agency, 'The Promulgation of the Interim Regulations on the Board of Supervisors for State-Owned Enterprises, and the Interim Regulations on the Board of Supervisors for State-Owned Key Financial Institutions [guoyou qiye jianshihui zhanxing tiaoli, guoyou zhongdian jinrong jigou jianshihui zhanxing tiaoli fabu]', *People's Daily [Overseas Edition]*, 1 (March 22, 2000).

⁹ See Chinaonline, 'New Rules Released for China's State-Owned Financial Firms' (March 23, 2000), available at '<http://www.chinaonline.com/topstories/000323/2/B200032201.asp>'.

control of key state-owned financial institutions over their asset quality and the hedging and appreciation of the state-owned assets.¹⁰ The duties of the board of supervisors of a state-owned financial institution (SOFI) include:¹¹ (1) ensuring that the SOFI operate in compliance with laws, administrative regulations and rules; (2) overseeing the SOFI's financial affairs, auditing accounting books and other records relating to its business activities, and verifying the authenticity and legality of its financial reports and main activity records; (3) inspecting the SOFI's economic efficiency, profit distribution, retained and added value of state-owned assets, and capital arrangement; and (4) examining and evaluating the performance of the SOFI's chief executives, including directors, governors, or managers; and proposing for rewards and punishment, and for appointment or removals.

¹⁰ *Supra* note 8.

¹¹ *Supra* note 9.

ANNEX XV: EFFORTS OF THE PBOC TO HELP COMMERCIAL BANKS OBTAIN EXTERNAL INFORMATION

1. Borrowing License and the National Credit Registration and Information Management System

To encourage banks to lend prudently, the PBOC instituted a system of borrowing license in April 1996. An enterprise must hold a borrowing license before they can open account with or borrow from major state banks.¹ The license carried information on an enterprise's credit record and current financial condition. Because the license was restricted to use only in the region in which the enterprise was located. Delinquent borrowers often took this loophole by going to banks in other regions.²

In 1997, the PBOC started to computerize the management of borrowing license. Under the new scheme, an enterprise must produce a plastic loan card when applying loan from a bank. The plastic card could be fed into a computer that would then retrieve the credit data of the borrower and thus allowed banks to assess whether the potential client is reliable and creditworthy.³ Great progress had been made in the construction of this new information system for credit and loan registration by the end of 1999: at least preliminary versions of this system were established in 301 cities available to Chinese and foreign financial institutions, covering more than 1m borrowers including many companies, work units and other financial organizations that do credit and loan business with banks.⁴

In early 2000, the PBOC promulgated the Measures on Bank Credit Registration and Information Management (Trial), to implement a national bank credit registration and information management system. The system intends to reveal borrowers' credit status quickly and comprehensively, and to prevent debtors from dodging their debts by borrowing repeatedly based on mortgaged assets. Moreover, the system intends to collect information on an enterprise's loans, bank drafts, letter of credits, guarantees, letters of guarantee, credit lines, corporations' interest defaults, debt non-payments, economic disputes, stock issues and

¹ See Lardy, Nicholas R., *China's Unfinished Economic Revolution*, 270 & note 3 of Chapter 4 (1998).

² See Liang, Minggao, 'Accelerate Loan Registration System Construction [jiakui yinhang xingdai dengji zhixun xitong jianshe, gouzhu zhongguo shehui xingyong tixi]', *China Finance* No. 4, 36-37, 49, at 36 (April 2000).

³ *Id.*

⁴ See Tian, Li, 'Measures to Prevent Credit Risks [fangfan xindai fengxian you baozhang]', *People's Daily (Overseas Edition)*, 3 (January 29, 2000).

corporate bonds. The PBOC Measures request that all financially institutions in China — including banks, co-operatives, trust and investment companies, finance companies and financial leasing companies — to participate in the system.⁵

2. Efforts to Establish China's Individual Creditworthiness System

Efforts have also been made to monitor the creditworthiness of individual borrowers as well. The first step was the introduction of a real-name identification system for household savings on April 1, 2000,⁶ creating conditions for banks to monitor the creditworthiness of individuals through their accounts with the banks.⁷

Besides, it was reported that China's first consumer credit bureau, the Shanghai Personal Credit Data Center, obtained the approval from the PBOC in April 2000. The credit company would investigate individuals' consumer credit, to help banks decide to whom they should make consumer loans. The credit bureau is connected with the computer networks of 15 commercial banks and their 300 branches across China.⁸

⁵ See Chinaonline, 'China to Introduce Credit Information Mgmt System' (February 29, 2000), available at <http://www.chinaonline.com/topstories/000229/2/C00022407.asp>.

⁶ See Chinaonline, 'Real-Name Ids Required for Personal Bank Accounts in China' (April 3, 2000), available at <http://www.chinaonline.com/topstories/000403/2/C00033111.asp>.

⁷ See Li, Shoujun, 'Studies on Establishing China's Individual Creditworthiness System [guanyu jianli woguo geren xinyong zhidu de tuantao]', *China Finance* No. 12, 28, at 28 (December 1999).

⁸ See Chinaonline, 'China Gains First Consumer Credit Bureau' (April 6, 2000), available at <http://www.chinaonline.com/topstories/000406/2/C00040508.asp>.

ANNEX XVI: THE GITIC BANKRUPTCY CASE

1. Fact

The Guangdong International Trust and Investment Company¹ is the first state-owned financial institution to go bankruptcy.² The GITIC case involves the largest-ever amount of assets in a Chinese bankruptcy case.

On October 6, 1998, the PBOC issued a notice [the “PBOC Notice”] stating that GITIC was unable to pay its matured debts and that in order to protect the lawful rights of its creditors, the PBOC had closed GITIC and revoked the financial licenses of GITIC and its branches.³

According to the Notice, the PBOC set up a liquidation group to carry out GITIC’s closure liquidation. During the liquidation process, all outstanding debts owed to and by GITIC would be placed under the custody of the BOC and the management of GITIC’s securities businesses be entrusted to Guangfa Securities Company, one of the leading securities firms in China.⁴ On the same date, the BOC issued a notice [the “BOC Notice”], which among other things, stated that the period for registration⁵ of rights and liabilities of GITIC would be from October 6, 1998 to January 6, 1999.⁶

The three-month liquidation, however, found GITIC was insolvent. GITIC’s board of directors decided that GITIC and three of its over 200 subsidiaries — GITIC Shenzhen Company, Guangdong International Leasing Company and Guangxin Development

¹ GITIC was established in July 1980 as a wholly owned entity of the Guangdong Provincial People’s Government. It obtained approval as a non-bank financial institution from the PBOC with authority to deal in foreign exchange in 1983. Shortly after its establishment, GITIC became an important fund-raising vehicle for Guangdong. In 1994, GITIC’s assets were valued at tens of billions of RMB. It became a financial consortium with an exceptional degree of autonomy, with some 300 subsidiaries at home and abroad. In addition to its investments in finance, bonds, trade, hotels, tourism and investment consulting, it had over the years also become involved in several dozen industrial production fields. Unfortunately, GITIC has also put a huge amount of money into high-risk real estate development. In October 1998, GITIC was judged incapable of keeping up with debt service on domestic and overseas debts and was shut down by the central government. See, e.g., Chinaonline, ‘The Spectacular Rise and Fall of GITIC’ (May 18, 1999), available at http://www.chinaonline.com/top_stories/breakingnews_b2_99051423.html.

² See, e.g., Chinaonline, ‘Q&A: Guangdong Deputy Governor Speaks on Gitic and Guangdong Enterprise’, available at http://www.chinaonline.com/top_stories/breakingnews_b2-99031516.html.

³ See Kynge, James & Harding, James, ‘China Suffers Biggest Financial Failure’, *Fin. Times* (October 7, 1998).

⁴ See Lam, Joseph, ‘The Closure of GITIC’, *J.I.B.L.* No. 4, 127, at 127 (1999); and Chang, TK, ‘The Easter Is in the Red’, *International Financial Law Review*, 43, at 44 (March, 1999).

⁵ The actual debt registration form is a one-page printed form with various blanks to be filled in concerning the debt in question, and contemplates that the creditor would attach any necessary attachments to the form. See Chang, TK, *supra* note 4.

⁶ See Chang, TK, *supra* note 4; and Lam, Joseph, *supra* note 4.

Enterprise — would apply for bankruptcy.⁷ On January 11, 1999, GITIC filed a petition for bankruptcy with the Guangdong Provincial High People's Court. On the same date, the Court issued a notice to the creditors of GITIC inviting them to attend the Court on January 16, 1999. On January 15, 1999, the Court issued a public notice of accepting the bankruptcy petition.⁸ On January 16, 1999, the Court issued a separate public notice of bankruptcy, stating that the Court declared GITIC bankrupt on January 16, 1999 in accordance with the first paragraph of Article 3, Article 8 and Article 23 (1) of the Enterprise Bankruptcy Law on the grounds that (1) the management of GITIC is disorganized, (2) GITIC's liabilities substantially exceed its assets, and (3) GITIC is unable to pay its huge debts on time.⁹ KPMG Huazhen Accounting and two law firms were appointed to handle the cleanup of the bankrupt trust — to clear the debts and to oversee investment projects of GITIC and its subsidiaries, and to collect money from GITIC's debtors. The notice further provided that as from January 16, 1999 on, GITIC would lose its right to dispose of its assets and that the liquidation committee appointed by the Court would take over GITIC.¹⁰

In April 1999, the first creditors' meeting after the initiation of the bankruptcy procedure was held in Guangdong. A creditors' committee was set up at the meeting to oversee the disposal of the failed company's assets.¹¹ On October 22, the second creditors' meeting was held. At the meeting, the liquidating committee informed creditors that GITIC's liquidators recognized creditors' claims of RMB24.33bn from a total of RMB38.9bn.¹² The

⁷ See Zhu, Jun, 'Closure of Financial Institutions in China' in *Strengthening the Banking System in China: Issues and Experience*, BIS Policy Papers No. 7, 304, at 313 (October 1999). GITIC's liquidation proceedings were handled in four parts: GITIC headquarters (heard by the High People's Court of Guangdong Province), Guangxing Enterprise Co. (heard by Guangzhou Intermediate People's Court), GITIC Shenzhen Co. Ltd. (heard by the Shenzhen Intermediate People's Court) and Guangdong International Leasing Co. Ltd. (heard by Guangzhou Intermediate People's Court). See China Business Information Network, 'China: Court Hearing Begins on Bankruptcy of GITIC in Shenzhen' (April 22, 1999), available at '1999 WL 5618970'. For the purpose of this annex, we will only discuss the bankruptcy of GITIC headquarters.

⁸ For details of this acceptance notice, see Lam, Joseph, 'The Insolvency of GITIC', *J.I.B.L* No. 6, 193, at 193 (1999).

⁹ *Id.*, at 194.

¹⁰ See Chinaonline, 'Chinese Court Declares Gitic Bankrupt', available at 'http://www.chinaonline.com/top_stories/today_b2_99011803.html'.

¹¹ See, e.g., Jacob, Rahul & Lucas, Louise, 'China: Government Details Gitic Assets', *Fin. Times* (April 23, 1999).

¹² See Lin, Ho Swee, 'GITIC: Payout Blow for Creditors', *Fin. Times* (October 23, 1999). The reduction was mainly attributed to unregistered overseas debts. GITIC refused to acknowledge claims for RMB14.464bn (\$1.75bn) of debt that were not formally registered with the State Administration of Foreign Exchange. The Guangdong Provincial Court confirmed the refusal at the second creditor's meeting on October 22, and gave creditors 15 days to object to the decision. See Chinaonline, 'Creditors of China's Gitic Object to Plan' (November 9, 1999), available at '<http://www.chinaonline.com/topstories/C9110807.asp>'.

third creditors' meeting was held in Guangdong on October 31, 2000. Each creditor was allowed to claim 3.38% of the confirmed creditor's rights amount.¹³

2. The Consequences of GITIC Case

Via the bankruptcy of GITIC, China has established clearly that it will not fall into the moral hazard trap of rescuing badly run companies just because they are too big to fail. Consequently, Chinese companies will no longer be able to obtain easy credit on the basis of opaque financial statements, personal connections and vague comfort letter from their parent government authorities. Foreign banks and investors will increasingly become the enforcer of the market discipline that China's lenders had been unable to impose by administrative fiat, thereby helping to impose hard budget constraints on SOEs.¹⁴

There are negative effects, however. In the wake of GITIC bankruptcy, foreign lenders severely contracted credit to the PRC companies. In some cases, they even pulled credit lines and demanded early repayment. International capital market financing virtually came to a standstill, with several abortive listing of the PRC companies on the Hong Kong Stock Exchange.¹⁵

Being scared by the impacts of the GITIC bankruptcy, the Monetary Policy Committee of the PBOC issued a statement after a policy conference recommending that restructuring should be the first priority when addressing problems at china's small and medium-sized financial institutions. The committee also said that eliminating all outstanding financial risks should be a priority during restructuring.¹⁶ Zhu Rongji, the Premier of China suggested that Beijing was working to restructure its debt-laden non-banking financial institutions rather than allowing them to go bankrupt, as it had in the case of GITIC.¹⁷ Dai,

¹³ See, e.g., Chinaonline, 'GITIC Distributes US\$84.5 Million to Creditors' (November 7, 2000), available at <http://www.chinaonline.com/topstories/001107/C00103110.asp>.

¹⁴ See Chang, TK, *supra* note 4, at 43.

¹⁵ *Id.*

¹⁶ See, e.g., Chinaonline, 'China to Restructure, Not Bankrupt, Troubled Banks and Trusts', available at http://www.chinaonline.com/top_stories/breakingnews_b9032514.html.

¹⁷ See Miller, Matthew & Wong, Lana, 'Official Back Gzitic Revamp, Seek Reprieve Debt Officials Back Gzitic Rejig, Seek Standstill on Debts', *South China Morning Post* 1 (March 18, 1999). According to the spokesman of the PBOC, Zhu's comments "sent two messages to the outside world. One is that the central government will not be responsible for debts owed by local banks and financial institutions. The second is that the government hopes that no more financial institutions will become bankrupt. But this does not mean that banks will not be allowed to go bankrupt. If there is no other option, bankruptcy is the only solution." Quoted in AFX News, 'China Financial Institutions Must Receive PBOC Approval for Bankruptcy', available at '1999 WL 14935612'.

Xianglong, speaking on March 1 at the joint BIS/PBOC conference on strengthening the banking system in China, said that for financial institutions with payment difficulties, rehabilitation and rescue should take priority over closure and restructuring over bankruptcy.¹⁸ It seems that there will not be many bankruptcies of financial institutions in the near future.

¹⁸ See Dai, Xianglong, 'Opening Address' in *Strengthening the Banking System in China: Issues and Experience*, 11, at 14, BIS Policy Papers No. 7 (October, 1999).

ANNEX XVII: CHINA EVERBRIGHT BANK'S ACQUISITION OF CHINA INVESTMENT BANK'S COMMERCIAL BANKING ASSETS

China Everbright Bank's acquisition of the commercial banking assets of China's Investment Bank (CIB) is a typical purchase and assumption (P & A) case in China.¹

The CIB was a medium-sized financial institution in China.² The institution was set up in 1981 to reallocate funds from the World Bank,³ Asian Development Bank⁴ and foreign governments for small- and medium-sized industrial projects. It was converted into a commercial bank in 1994. The bank had trouble in reducing swelling NPLs and adjusting to increasing market competition in China's banking sector. Prior to its take-over by the State Development Bank (SDB), almost half of its assets were non-performing.

As part of the rescue plan, in December 1998, the CIB was merged into the State Development Bank (SDB). The SDB, being a government policy bank, would have to hive off the CIB's commercial banking operations because of government restrictions. Nine mainland banks were asked by the PBOC to bid for the CIB's assets before Everbright's restructuring plan was accepted.

The acquisition included the transfer of employees, loan portfolios and other assets. Everbright received the 137 banking offices of CIB, without payment, in return for taking over most of its assets and liabilities.

After the acquisition, China Everbright Bank almost doubled its asset to RMB 150 billion and greatly expanded its presence (the move increased its number of banking offices across the mainland to more than 240). The acquisition was supported by the government — all the foreign currency assets of CIB, some 80% of which were non-performing, were taken over by the Ministry of Finance (MOF).

¹ See, e.g., Macmahon, William J., 'Everbright and CIB Merge in a Strong Bank-Weak Bank Rescue', available at 'http://www.chinaonline.com/top_stories/breakingnews_b9031915.html'; Kynge, James, 'China: Everbright Acquires State Bank', *Fin. Times* (March 19, 1999); Wang Xiaowei, 'Huge Credit Risks Seen in CIB Acquisition Everbright Takes Over Bad Loans', *South China Morning Post* (March 19, 1999); and Wang, Xiaowei, 'Everbright to Double Assets CIB Branches Changing Hands', *South China Morning Post* (March 18, 1999).

² According to the CIB's 1997 report, it had total assets of RMB 74.69 by the end of the year, with 29 regional branches and more than 130 sub-branches across the country. The bank's outstanding loans were RMB 35.82 billion at the end of 1997, of which foreign currency loans amounted to US\$1.51 billion.

³ China entered into the World Bank in 1980. The World Bank approved its first loans to China in June 1981. Significant disbursements of these funds occurred after June 1982.

⁴ China became a member of the Asian Development Bank in 1986.

SELECTED BIBILIOGRAPHY

I. BOOKS AND ARTICLES IN CHINESE

- A Ming, 'State-Owned Enterprises: How to Confront the Debt Ratio?' *Jingrong Shibao (Beijing)*, 1 (October 7, 1995).
- Cao, Jianming, 'The Financial Safety and the Financial Legislation', *Faxue [Law Science]* No. 8, 2 (1998).
- CCB, 'CCB Is Enjoying A Rapid Development And Undertaking A Strategical Reform', *China Finance (Beijing)* No. 8, 9 (1998).
- Chen, Guangxin, '1997 Recorded an Appropriate Growth of Money Supply and an Obvious Increase of Foreign Reserves', *China Finance (Beijing)* No. 3, 19 (1998).
- Chen, Jianhua, 'The Reform of the PBOC's Organizational Structure [*gaige renhang guanli tizhi, wangshan jinrong tiaokong jianguan tishi*]', *China Finance (Beijing)* No. 11, 22 (November 1998).
- Chen, Jiansheng, 'Situation of China's Direct Finance and Indirect Finance', *China Finance (Beijing)* No. 6, 38 (1998).
- Chen, Kaixing, 'The Bankruptcy of Achen Sugar Mill Go to Its last Stage [*Achen Tangchang Pochan An Jingru Zhongjie Jieduan*]', *People's Daily (Oversea Edition)*, 1 (November 12, 1998).
- Chen, Letian, 'The Supervisory and Controlling Mechanism of Capital Market on Entrepreneurs', *Securities Market Herald (Shenzhen)* No. 4, 37 (1998).
- Chen, Shen, 'The Resolution Trust Corporation in the US', *China Finance (Beijing)* No. 6, 44 (1998).
- Chen, Xiaoyun, 'History and Prospects of China's Financial Legislative Activities [*woguo jinrong fazhi jianshe de lichen yu zhanwang*]', *China Finance (Beijing)* No. 12, 34-36, 64 (December 1998).
- Chen, Xiaoyun, 'Summarize Experiences and Strengthening Financial Lawmaking [*zongjie lifa jingyan, jiaqiang jinrong lifa*]', *China Finance (Beijing)*, No. 4, 7 (2000).
- Chen, Yin, 'Basic Ideas on China's Deposit Insurance System [*jianli woguo chunkun baoxian zhidu de jiben gouxiang*]', *Economic Science [jingji kexue]* No. 4, 25 (April, 1999).
- Chen, Yiyuan, *Loan Risk Classification Management [Daikuan Fengxian fenglei guanli]* (1999).
- Chen, Yuan (ed.), *Chinese Financial System Reform* (1994).
- China Finance Reporter, 'China's Trust and Investment Companies Achieved a Normative Development During Consolidation [*zai zhengdun zhong fazhan guifan fazhan zhongguo de xintuo ye*]', *China Finance (Beijing)* No. 6, 7 (June 1999).

- _____, 'Using Interest Rate to Lever the Economy [*yunyong lilv gongge, chujin jingji fazhan*]', *China Finance (Beijing)* No.7, 7 (July 1999).
- Comprehensive Unit of the Economic Research Institute, State Planning Commission, Macro-Economic Situation of the Year 1995-1996 [*1995-1996 nian hongguan jingji xingshi fenxi*] (Beijing, 1996).
- Dai, Gengyou, 'A Review of PBOC's Monetary and Credit Policy', *China Finance (Beijing)* No. 12, 27 (1999).
- Dai, Xianglong, 'Improve Financial Services to Assist Reform and Progress of SOEs in Accordance with the Guideline of 4th Plenary of the 15th Central Committee of CPC', *China Finance (Beijing)* No. 11, 4 (November 1999).
- _____, 'PBC Will Follow an Appropriate Monetary Policy and Focus on Improving Financial Supervision to Promote Sound Economic Development and Guarantee Safety', *China Finance (Beijing)* No. 2, 4 (1999).
- _____, 'The Objectives of a New Round of Financial Reform and Development', *China Finance (Beijing)* No. 2, 4 (1998).
- _____, 'To Accomplish a Solid Base for a Modern Banking System, We must Ameliorate Loan Classification and Improve Asset Quality', *China Finance (Beijing)* No. 7, 4 (1998).
- Dai, Yulin, 'Financial Creativity: Ways to Solve the Problem of Bad Debts between Banks and Enterprises', *Caijing Wenti Yanjiu*, 14-18 (August 1997).
- Ding, Jianming, 'Elimination of State-Owned Commercial Bank Lending Quota Controls', *People's Daily (overseas edition)*, 1 (December 26, 1995).
- Dong, Suping, *Issues on Socialist Financial and Banking* [*She Hui Zhu Yi Chai Zheng Jing Rong Wen Ti*], (1981).
- Du, Deqing, 'How Much will This Year's Government Debt Be?' *Jingrong Shibao*, 8 (November 9, 1998).
- Editorial Comment, 'A Major Reform to Macro Financial Regulation and Control [*jingrong hongguang tiaokong de zhongdagaige*]', *People's Daily* (December 26, 1997).
- _____, 'Join the WTO: Opportunities and Challenges to Chinese Banks [*rushi, zhongguo yinghangye mian ling de tiao zhan yu xuanzhe*]', *Modern Commercial Banking* [*Xiandai Shangye Yinghang*] No. 9, covering page (September 1999).
- Fan, Qixing, Wu, Yuyun & Yang Lixin, 'Necessity to Improve External Auditing of Commercial Banks [*shangye yinhang waibu shenji jidai wanshan*]', *China Finance* No. 4, 42 (April 2000).
- Fang, Gang, 'On "Comprehensive State Liabilities": How to Deal with Bank's Bad Assets [*lun "guojia zhonghe fuzhai", jianlun ruhe chuli yinghang buliang zhichan*]', *Economic Research Journal* No. 5, 11 (May 1999).
- Gao, Xiang, *On Price Reform* (Beijing, 1982).
- Gong, Wen & Huang, Rifei, 'The First Session of the Ninth National People's Congress Held Press Conference on SOE Reform and Reemployment [*Jiu Guoqi Gaige he Zhai*]

- Jiuye Deng Wenti Jiujie Renda Yichi Huiyi Juexing Jizhe Jiadaihui*], *People's Daily (Overseas Edition)*, 4 (March 9, 1998).
- Gou, Feng, 'Legal Issues Concerning Legal Person's Participation in the Secondary Stock Markets', *People's Daily (Overseas Edition)*, 7 (January 8, 2000).
- Gu, Genyun, 'On Financial Crisis and Its Legal Countermeasures', *Law Science [Fa Xue] (Shanghai)* No. 12, 45 (Decembre 1998).
- Gu, Yu, 'On Improving China's Irrecoverable Loan Provisioning System [*dui gaijing woguo daizhang zhunbeijing zhidu de shikao*]', *Journal of Finance* No. 1, 66 (1999).
- He, Jingsong, 'Achievements of Enterprise Merger and Bankruptcy in Six Industry Lines [*woguo liuda hangye jianbing pochan chengxiao mingxian*]', *People's Daily (Overseas Edition)*, 1 (August 3, 2000).
- He, Linxiang (Governor of the ABC), 'ABC Pressing Forward in China's Reform and Opening up', *China Finance (Beijing)* No. 8, 4 (1998).
- Historical Research Unit of the Central Committee of the Communist Party of China, 'Major Events after the Third Session of the Eleventh Central Committee of the Communist Party of China (II) [*zhonggong shiyijie sanzongquanhui yilei dashiji-zhong*]', *People's Daily (Overseas Edition)*, 3 (December 15, 1999).
- _____, 'Major Events after the Third Session of the Eleventh Central Committee of the Communist Party of China (III) [*zhonggong shiyijie sanzongquanhui yilei dashiji-xia*]', *People's Daily (Overseas Edition)*, 3 (December 15, 1999).
- Hou, Zhengxi, 'An Important Monetary Policy Instrument to Improve Financial Services: The PBOC Detailize Management on Rediscounting Facilities [*Gaishan Jinrong Fuwu de Zhongyao Houbi Zhenche Chuoshi: Zhongguo Renmin Yinhang Jinyibu Wangshan Zhaitianxian Guanli*]', *China Finance (Beijing)* No. 11, 19, 39 (November 1999).
- Hu, Zheyi, 'Memorandum of China's Financial Reform at the Turn of the Century (I) [*woguo kua shiji jinrong gaige beiwanglu (I)*]', *China Finance* No. 3, 18 (1999).
- Huang, Weiding, 'The Secrets of Chinese Billionaires', available at '<http://www.geocities.com/Athens/Parthenon/8094>'.
- Huang, Yuncheng, 'Bank Reform and Debt Restructuring', *Guanli Shijie (Beijing)* No. 6 (1996).
- ICBC Research Group, 'An Investigation Report on Issues in Enterprise Bankruptcy', *Jingji Yanjiu* No. 4, 15 (April 1997).
- Jiang, Chaoliang, et al., *Handbook for Five-level Loan Classification [daikuan wuji fenglei shucheng duben]* (1999).
- Jiang, Chun, 'On the Essence of Finance and Institutional Prerequisites [*lun jinrong de shizhi ji zhidu qianti*]', *Economic Research Journal* No. 7, 33 (July 1999).
- Jiang, Jianqing, 'China Banking Industry Association's Role in Bringing about a Sound Banking Industry [*fahui zhongguo yinhangye xianhui zhuoyong, chujing yinhangye jiankang fanzhan*]', *China Finance (Beijing)* No. 6, 11 (2000).

- Jiang, Qin Hai, 'On State Bank Ownership Reform [*lun guoyou yinhang de chanquan gaige*]', *China Finance (Beijing)* No. 9, 35-6 (September 1999).
- Jiang, Sidong *et al.*, 'Financial Reform, the Two-Track System: Strengthen Credit Restraint, Open up a Capital Market among the People', *Chinese Economic Structural Reform Research Institute (Beijing): Research Reports* No. 25 (November 29, 1985).
- Jiang, Xuejun & Liu, Yan, 'China's Financial Structures', *China Finance (Beijing)* No. 6, 43 (1998).
- Jiang, Zuqi, 'The Progress and Future of China's State Specialized Banks' Commercialization Reform', *Guoji Jinrong Yan Jiu* No. 1, 8 (January 1996).
- Jiao, Jingpu, 'Joining WTO and Its Implication for the Reform and Development of China's Banking Industry [*jiaruo WTO yu zhongguo yinghangye de gaige he fazhang*]', *China Finance (Beijing)* No. 1, 11 (2000).
- _____, 'New Development of China's Financial Reform [*zhongguo jinrong tizhi gaige xin fazhang*]', *China Finance (Beijing)* No. 10, 18 (1999).
- Jin, Weihong, 'An Empirical Study of Debt-Capital Ratio Management as Introduced by China's Specialized Banks', *Guanli Shijie* No. 3, 44 (1996).
- Kang, Shusheng, *Commercial Banks' Internal Controls: Borrowing and Innovation [*shangye yinhang neikong zhidu: jiejian yu chuangxing*]* (1999).
- Li, Chiliang, 'Realignment of Enterprise Debt', *Jingji cankaobao [Economic Reference News]* (Beijing), 1 (August 8, 1996).
- Li, Daokui & Li, Shan, 'A New Idea for SOEs' Debt Restructuring [*guoyou qiye zhaiwu chongzhu de yige xin shilu*]' in Wu, Tianlin (ed.), *Theory and Practices of State Sector Debt Restructuring [*guoyou jingji zhaiwu chongzhu lilun yu shiwu*]*, 77 (1997).
- Li, Junjie, 'The Dispatch of Bank NPLs and The Operation of AMCs [*yinhang buliang zichan boli he zichan guanli gongshi de yunzhou*]', *Modern Commercial Banking* No. 9, 8 (September 1999).
- Li, Lin, 'The Survival Crisis Threatening State Commercial Banks', *Xiandai Jingrong Daokan* No. 1 (1996).
- Li, Shoujun, 'Studies on Establishing China's Individual Creditworthiness System [*guanyu jianli woguo geren xinyong zhidu de tuantao*]', *China Finance* No. 12, 28 (December 1999).
- Li, Tianying, 'The Foundation of Socialist Market Economic Theory and A Significant Breakthrough — in Commemoration of the 20th Anniversary of the 3rd Plenary Session of the 11th Central Committee of CPC [*shehui zhuyi shichang jingji lilun de xingcheng he zhongda tupo- jinian zhongguo gongchandang di shiyijie sanzong quanhui ershi zhounian*]', *Economic Research Journal* No. 3, 3 (March 1999).
- Li, Xi & Han, Jian, 'An International View on Pension Funds, Insurance Funds and Investment Funds', *Securities Market Herald* (Shenzhen) No. 4, 28 (1998).
- Li, Xia & Wang, Xing, 'Debt-Equity Swap Started in China [*zhanzhuanggu jingru shizixing chaozhou*]', *Jingrong Shibao*, 12 (September 15, 1999).

- Li, Xia, “Debt-equity Swaps Should be Carried out On the Commercial Basis [*zhaizhuanggu yunzhou ying gengjia shichang hua*]’, *Jingrong Shibao*, 12 (September 15, 1999).
- _____, ‘The Scope and Preconditions for Candidate Enterprises for the Debt-Equity Swap Scheme [*shishi zhaizhuanggu qiye de fangwei yu tiaojian*]’, *Jingrong Shibao*, 12 (September 15, 1999).
- Li, Xinxin, ‘Looking at China’s Hidden Financial Danger from the Perspective of the East Asian Financial Crisis: An Analysis of the Utilization and Management of Assets by China’s State-Owned Commercial Banks’, *Gaige (Beijing)* No. 3, 33 (1998).
- Li, Zhiqiang, ‘Background and Possible Effects of Tax Policy Adjustment for Financial and Insurance Sectors’, *Zhonguo Shuiwu Bao* (May 23, 1997).
- Liang, Minggao, ‘Accelerate Loan Registration System Construction [*jiakui yinhang xingdai dengji zhixun xitong jianshe, gouzhu zhongguo shehui xingyong tixi*]’, *China Finance (Beijing)* No. 4, 36-37, 49 (April 2000).
- Liao, Shuhui, ‘On China’s Present Financial Reform’, *Lilun Yuekan (Beijing)* No. 9 (September 1987), in FBIS-87-206.
- Liu, Bin (Statistics Department of the PBOC), ‘A Survey on the Loan Extending Behavior of Chinese Commercial Banks’, *China Finance (Beijing)* No. 9, 27 (1998).
- _____, ‘Channels to Widen the Direct Finance’, *China Finance (Beijing)* No. 3, 30 (1998).
- Liu, Chongming, ‘The Accomplishment and Future Direction of PBOC’s Financial Supervision’, *China Finance (Beijing)* No. 12, 31 (1998).
- Liu, Hengbao (ABC), ‘Twenty Year’s of Splendid Achievements of the Rural Finance’, *China Finance (Beijing)* No. 10, 14 (1998).
- Liu, Min, ‘The Operation of “Debt-equity Swaps”: the Exit of AMCs [*zhaizhuanggu shishi ji tuichu fangshi chutuan*]’, *Jingrong Shibao*, 12 (September 15, 1999).
- Liu, Tinghuan (Governor of the ICBC), ‘ICBC’s 20 Years of Reform and Development’, *China Finance (Beijing)* No. 7, 7 (1998).
- _____, ‘The Reform of SOEs and the ICBC’, *China Finance (Beijing)* No. 1, 8 (1998).
- Liu, Zhangjun & Liu, Xiaoyong, ‘Enhance Risk-prevention, Promote the Off-site Surveillance System in China [*jiaqiang fengxian fangfang, jiji tuijin woguo yinhangye fexianchang jianguan tixi jianshe*]’ in *Handbook of Off-site Surveillance for Commercial Banks* [*shangye yinhang feixianchang jianguan gongzhuo shuochu*], 1 (China Finance Press, 1999).
- Liu, Zhunyi & Qian, Yinyi, ‘Proposals for Bank/Enterprise Financial Restructuring [*guanyu zhongou de yinhang yu qiye caiwu chongzhu de jianyi*]’, *Jingji yu Shehui Tizhi Bijiao* No. 5 (1994).
- Lu, Xianxiang, ‘Problems with the Three Lending Models of China’s Commercial Banks’, *Guoji Jingrong Yanjiu* No. 12 (1996).
- Lu, Xueyong (The PBOC Beijing Branch Director), ‘The Change of the Central Bank’s Macro-Regulation Method: A Review after the 5th Interest Rate Reduction’, *China Finance (Beijing)* No. 8, 12 (1998).

- Lu, Xueyong, 'The Change of the Central Bank's Macro-Regulation Method: A Review after the Fifth Interest Rate Reduction', *China Finance (Beijing)* No. 8, 12 (1998).
- Luo, Lan, 'The Goal of SOEs Going out of Red in Three Years Is Expected to Be Achieved This Year [*Guoqi Sannina Taikun mubiao jinjiang ke ruqi shixiang*]', *People's Daily (Overseas Edition)*, 1 (January 26, 2000).
- Ma, Junqi, 'PBOC Will Introduce Financial Supervision Responsibility System [*mingque jianguan zeren, tigao jianguan xiaoli- jianjie "zhongguo renmin yinhang jingrong jianguan zerenzhi" (zhaixiang)*]', *China Finance (Beijing)* No. 7, 12 (July 1999).
- Ma, Xinpin, Hong Zheng, 'Insufficient Demand, Insufficient Creditworthiness [*xvqiu buzhu, xinyong youqi buzhu*]', *Jingrong Shibao*, 2 (September 8, 1999).
- Meng, Long, 'The Basle Core Principles and China Financial Regulation and Supervision [*baser hexing yuanze yu zhongguo de jingrong jianguan*]', *China Finance (Beijing)* No. 7, 14, at 14, 16 (1999).
- Metropolitan Finance Society of Hunan Province, 'The Situation of Bad Assets in Specialized State Banks', *Jingji Yanjiu Zhiliao* No. 1 (1995).
- Mo, Xvdong, 'Emperical Studies on the Restructuring of Listed Companies in Deficit', *Securities Market Heralds (Shenzhen)* No. 3, 4 (1998).
- Mou, Ling, 'Stride Toward a Completely New System', *Jingrong Shibao*, 1 (June 14, 1995).
- Mu Ren, 'Really Going to Bankrupt, or Just to Dodge the Creditors?' *People's Daily*, December 9, 1996.
- Ni, Shiyi, 'China's Court Improve the Judges Withdrawal System [*zhongguo fayu wangshang shenpan ren yuan huibi zhidu*]', *People's Daily (Overseas Edition)*, 4 (February 1, 2000).
- Pan, Qin, 'A New Stage for China's Securities Markets [*zhongguo zhengquan shichang maishang xin taijie*]', *People's Daily (Overseas Edition)*, 5 (January 22, 2000).
- Pan, Xinglin, *Legal Issues Concerning the Central Bank Independence* [*zhongyan yinghang dulixing falv wenti yanjiu*], unpublished LLM thesis of the China People's University (July, 2000), on file with the author.
- Pan, Yanxi, 'Beijing Cement Limited Liability Corporation Established after Debt-Equity Swap [*quanguo shuojia zhaizhuanggu gongshi zai jing chengli*]', *People's Daily (Overseas Edition)*, 1 (June 29, 2000).
- Pan, Yue (ed.), *Policies and Procedures for Asset Restructuring* (Beijing, 1997).
- People's Daily Commentator, 'An Significant Reform of the PBOC Organizational System [*zhongyan yinhang guanli tizhi de zhongda gaige*]', *People's Daily (Overseas Edition)*, 1 (November 16, 1998).
- People's Daily, 'According to the CSRC Chairman Zhou Zhengqing, Securities Market Is to Play More Important Role in China's Economy [*zhongguo zhengquanhui zhushi zhou zhengqing cheng zhengquan shichang jiang fahui genjian zhongyao de zhouyong*]', *People's Daily (Overseas Edition)*, 5 (January 8, 2000).

- _____, 'Reviewing the Pilot Sale of State Shares in Listed Companies', *People's Daily (Overseas Edition)*, 7 (January 8, 2000).
- _____, 'The Four AMCs Has Reached Debt-Equity Swap Agreements Worth of RMB83.4bn', *People's Daily*, 5 (January 8, 2000).
- Planning and Fiscal Department of CBC, 'Ratio Management's Role in Improving Resource Allocation', *China Finance (Beijing)* No. 3, 11 (1998).
- Planning Department of ABC: Li Huatian, 'Commercial Bank's Control of Loan Scale After the Removal of Credit Ceiling', *China Finance (Beijing)* No. 3, 10 (1998).
- Planning Department of ICBC: Liu, Yuhua, 'Assets Management in the Commercialization of State-Owned Banks', *China Finance (Beijing)* No. 3, 9 (1998).
- Policy Study Office of PBOC, *Issues on Bank and Enterprise Debt Restructuring [Yinhang yu Qiye Zhaiwu Chongzhu Wenti Yanjiu]* (Beijing, 1995).
- Qing, Chi-jiang, 'Bank NPL Problem in China' in Policy Study Office of PBOC, *Issues on Bank and Enterprise Debt Restructuring*, 20 (Beijing 1995).
- Qiu, Bin & Bian, Weigang, 'On Bank Lending Strategy Adjustments [*qiantan xinxingshi xia yinhang xindai chele de tiaozheng*]', *China Finance* No. 7, 10 (1999).
- Qiu, Mingchen, 'On the Way to Advance the Transformation of the Method of Managing Credit Funds', *Jirong Shibao (Beijing)*, 5 (May 18, 1996).
- Ren, Weidong, 'New Measures for New Share Offerings [*woguo shixing xingu faxing xinbanfa*]', *People's Daily (Overseas Edition)*, 1 (February 14, 2000).
- Ren, Weidong & Lv, Peng, 'The Development of Securities Market in the Year 1999 [*Zhengquan shichang buduan guifan qvde jingyibu fazhan, jingnian jiang zhuoli zhahao shijian dashi*]', *People's Daily (Overseas Edition)*, 5 (January 29, 2000).
- Ruan, Hong, 'The Bank of Communications— The Rise of a National Shareholding Commercial Bank', *China Finance (Beijing)* No. 10, 19 (October 1993).
- Shen, Pei, 'Proposed Structures for NPL Securitization in China [*buliang daikun zhengquanhua de chaozhuo gouxiang*]', *Jinrong Shibao*, 8 (July 3, 1999).
- Shi, Mingde, 'The CSRC Director Talks about China's Securities Markets [*woguo zhengquan shichang fazhang qvshi xianghao*]', *People's Daily (Overseas Edition)*, 2 (March 12, 1998).
- Shi, Runmei, 'Cinda AMC Set up Office in Urumqi [*xinda zichan guanli gongshi urumuqi bangshichu chengli*]', *Jingrong Shibao*, 12 (September 9, 1999).
- Shui, Ji & Shi, Mingshen, 'The CPC Central Committee and the State Council Decide to Reform the PBOC Organizational System [*zhonggong zhongyan guowuyuan zhuochu jueding, zhongguorenminyinhang guanli tizhi shixing gaige*]', *People's Daily (Overseas Edition)*, 1 & 4 (November 16, 1998).
- Song, Bo, 'Proposals on the Commercial Bank's Bad Loan Workout', *China Finance (Beijing)* No. 1, 23 (1998).
- Song, Hailin, 'The Influences of Enterprise Reform on Loan Quality and Its Solution', *China Finance (Beijing)* No. 3, 33 (1998).

- Song, Qinhua, 'The Situation of State Banks' Loan Losses and Its Causes', *Jingji Yanjiu* No. 8 (1996).
- State Foreign Exchange Administration: Liu, Guangcan & Zhang, Xiaopu, 'China's Balance of Payments: 1997's Situation and 1998's Prospect', *China Finance (Beijing)* No. 7, 38 (1998).
- Statistics Department of the PBOC, 'An Analysis of the Direct Finance of Chinese Enterprises', *China Finance (Beijing)* No. 9, 24 (1998).
- Stiglitz, Joseph E., 'Second-Generation Strategies for Reform for China (zhongguo dierbu gaige zhanlue)', *People's Daily (Overseas Edition)*, 2 & 3 (November 13, 1998). An English version is available at 'http://www.worldbank.org/html/extdr/extme/jssp072098.htm'.
- Sun, Jie, 'The PBOC Monetary Policy Commission Held Its Second Quarterly Meeting for 2000 to Determine Future Monetary Policy [yanghang huobi zhengche weiyuanhui zhaokai dier jidu lihui que ding jinhou yiduan shijian houbi zhengche zhongdian]', *People's Daily (Overseas Edition)*, 1 (April 25, 2000).
- Sun, Shuangrui, 'Subordinate Specialized Bank Commercialization to Enterprise Reform', *Caimao Jingji [Finance and Trade Economics]* No. 3 (March 1995), in FBIS, China, 96-048 (March 11, 1996).
- Tan, Jingshun, 'Carry out the Spirit of 4th Plenary of 15th Central Committee of CPC and Assist the Reform and Progress of SOEs in Old Industrial Bases [guanche sizhong quanhui jingshen, zhichi dongbei lao gongye jidi guoqi gaige he fanzhang]', *China Finance (Beijing)* No. 12, 4 (December 1999).
- Tan, Ruyong, 'An Empirical Study of the Relationship between China's Financial Development and Economic Growth [zhongguo jinrong fanzhang he jingji zhengzhang guanxi de shizheng yanjiu]', *Economic Research journal [jingji yanjiu]*, No. 10, 53 (October 1999).
- Tang, Shuangning, 'Ameliorate Financial Services to Support Economic Development', *China Finance (Beijing)* No. 7, 11 (1998).
- Tang, Xiong, 'How to Regard the Bank's Non-Performing Assets', *Jingrong Shibao (Financial Times)*, 5 (April 21, 1996).
- Tao, Shigui, 'The Comparison of Profitability Between State Commercial Banks and Foreign-Invested Banks in China', *Jingji Yanjiu Ziliao (Beijing)* No. 3 (1996).
- Task Team of Xiamen University, 'Credit Assets, Risk of State-Owned Commercial Bank: The Prevention of Their Increase and the Dissolution of Their Stock [guoyou shangye yinghang xingdai zichan fengxian: Zhenliang fangfan yu chunliang huajie]', *Economic Research Journal* No. 5, 18 (May 1999).
- The State Council Secretary Department (ed.), *The Organization Structure of the Central Government [zhongyan zhengfu zhuzhi jigou]* (1998).
- The Task Team of the PBOC Huaihua Branch, 'Depositors' Consciousness of Financial Risks and the Bank Exit System [chunliang ren de fengxian yishi yu yinghangye de tuichu zhidu], *Jinrong Jingji (Changsha)* No. 9, 3-6 (1998).

- Tian, Li, 'Measures to Prevent Credit Risks [*fangfan xindai fengxian you baozhang*]', *People's Daily (Overseas Edition)*, 3 (January 29, 2000).
- _____, 'China Bank Sign First Stock Collateral Loan Agreement [*juanshang gupiao ziya daikuan xieyi shouqian*]', *People's Daily (Overseas Edition)*, 5 (March 4, 2000).
- _____, 'Private Individuals Cannot Establish Banks Themselves but Are Allowed to Hold Shares in Banks [*shiren buxv ban yinhang dan ke rugu*]', *People's Daily (Overseas Edition)*, 2 (January 27, 2000).
- _____, 'Targets of Financial Macro-regulation Were Achieved in 1999 [*qvnian jinrong hongguan tiaokong mubiao shixian*]', *People's Daily (Overseas Edition)*, 1 (January 21, 2000).
- _____, 'The CIRC Was Established in Beijing Today [*Zhongguo Baoxian Jiandu Weiyuanhui Zai Jing Chengli*]', *People's Daily (Overseas Edition)* 1 (November 19, 1999).
- _____, 'The Economic Growth is the Foundation for the Increase in Tax Revenue [*Jingji Fazhan shi Shuishou Zhenzhang de jichu*]', *People's Daily (Overseas Edition)*, 2 (January 18, 2000).
- _____, 'The Establishment of ICBC & East Asian Financial Holding Ltd. [*Gongshang Dongya Jinrong Konggu Youxian Gongshi Chengli*]', *People's Daily (Overseas Edition)*, 1 (February 26, 1998).
- _____, 'The PBOC Statistics Show Stable Financial Situation in the Past Year 1999 [*zhongguo Renmin Yinhang Tongji Baogao Xianshi Qvnina Jinrong Yunxing Pingwen*]', *People's Daily (Overseas Edition)*, 1 (January 13, 2000).
- Tokyo Representative Office of the PBOC: Luo, Qing, 'Japan's Financial Reform and the Difficulties it Encountered', *China Finance (Beijing)* No. 10, 34 (1998).
- Wan, Jianhua, 'China's Commercial Banks Should Pay Attention to and Improve Their Liquidity Management', *China Finance (Beijing)* No. 6, 16 (1998).
- Wang, Baoqing, 'PBOC Official Explains the *Interim Measures Governing Closed-End Loans* to Reporter [*jiu fengbi daikun guanli zhanxing banfa, renhang youguan fuzeren da jizhe wen*]', *Jinrong Shibao*, 1 & 2 (August 3, 1999).
- _____, 'The Enhancing Financial Supervision and Administration in China [*changyin zaishou-woguo jinrong jianguan buduan jiaqiang*]', *Jinrong Shibao* 1 (October 10, 1999).
- Wang, Hailin, Chui, Ligu, 'Legal Issues Concerning the Closure of Financial Institutions [*guanbi jinrong jigou youguan falv wenti de jidian shikao*]', *People's Daily (Overseas Edition)*, 5 (October 3, 1998).
- Wang, Hongyan, 'The First Regional PBOC Branches Opened in Shanghai [*shoujia kua xingzhengqv yanhang fenghang zai hu gua pai*]', *People's Daily (Overseas Edition)*, 1 (November 19, 1998).
- Wang, HongZhang, 'Internal Control: Present Situation and Reform Proposal', *China Finance (Beijing)* No. 1, 17 (1998).
- Wang, Hui, 'Incentives Behind Extensive Household Savings [*chuxvre de dongji fengxi*]', *China Finance* No. 10, 32 & 34 (October, 1999).

- Wang, Jun, 'The Implication, Principle and Implementation of Loan Risk Classification', *China Finance (Beijing)* No. 4, 11 (1998).
- Wang, Kaiguo, 'Thinking on the Issues of Pursuing Asset Securitization in China [guanyu zhongguo tuixing zhichan zhengquanhua wenti de shikao]', *Economic Research Journal* No. 6, 29 (1999).
- Wang, Kejing, 'China's Commercial Bank's Reporting Obligation', *China Finance (Beijing)* No. 7, 21 (1998).
- Wang, Wuyi, 'Analyzing Factors Influencing the Bankruptcies of China's State-Owned Enterprises', *Jingji Yanjiu (Beijing)*, 41 (June 20, 1994).
- Wang, Zhaoxing, 'Financial Supervision: Opportunities and Challenge [jingrong jiaguan: fazhan yu tiaozhan]', *China Finance (Beijing)* No. 12, 16 (1999).
- Wang, Zheng, 'Going Bankrupt in Accordance with the Law- Practices in Shenyang', *People's Daily* (18 November 1996).
- Wei, Gejun & Chu, Eiwu, 'Enhance the Management of Loans, Protecting Financial Assets [qianshi jiaqiang jinrong zhaiquan guanli, jijue weihu jinrong zichan anquan]', *China Finance* No. 10, 31 & 44 (October, 1999).
- Wei, Wenshen & Xia, Huiming, 'Risks Related to Unfair Competition', *China Finance (Beijing)* No. 8, 45 (1998).
- Wen, Zongyu & Zhao, Qingmin, 'On Financial Reform and SOE's Strategic Restructuring [shenhua jinrong tizhi gaige yu guoyou qiye zhanlexing gaizhu]', *China Finance* No. 12, 9 (December 1999).
- Wu, Changming & Gao, Jiefa, 'Issues Relating to the Five-level Loan Classification System', *China Finance (Beijing)* No. 8, 18 (1998).
- Wu, Xiaolin & Xie, Pin, 'Some Ideas about SOE's Debt Restructuring' in Policy Study Office of PBOC, *Issues on Bank and Enterprise Debt Restructuring*, 1 (Beijing 1995).
- Wu, Yin, 'Merger & Restructure: the International Tendency of the Banking Industry and its Implications to China', *Chengshi Jinrongbao (Beijing)* (July 21, 1998).
- Wu, Youchang & Zhao, Xiao, 'Debt-to-Equity Swap: A Theoretical and Policy Analysis Based on Corporate Governance [zhaozhuangu: jiyu qiye zhili jiegou de lilun yu zhenche fengxi]', *Economic Research Journal [jingji yanjiu]* No. 2, 26 (February 2000).
- Xiang, Xiaofang, 'Win Early in the Battle: A Short Note on Huaxia Bank's Corporatization System Reform', *Jingrong Shibao (Beijing)*, 1 (September 6, 1996).
- Xie, Ping, 'On the Reform of State-owned Specialized Banks', *Jingji Yanjiu* No. 2, 23 (February 1994).
- Xinhua News Agency, 'China's Economy Enters the Secondary Growth Stage [Zhongguo Jingji Zhengzai Jingru Cigao Zhengzhang Jieduan]', *People's Daily (Overseas Edition)*, 2 (December 7, 1998).
- _____, 'The Ministry of Finance is to Issue Special Treasury Bonds Worth RMB270 to Enhance the Capital of State Owned Commercial Banks [Buchong Guoyou duzi

- Shangye Yinghang Zibenjing, Caizhengbu Faxing 2700yi Tebie Guozhai*], *People's Daily (Overseas Edition)*, 1 (March 2, 1998).
- _____, 'The National Tax Revenues Reached More than RMB1000bn', *People's Daily (Overseas Edition)*, 1 (January 3, 1999).
- _____, 'The Promulgation of the Interim Regulations on the Board of Supervisors for State-Owned Enterprises, and the Interim Regulations on the Board of Supervisors for State-Owned Key Financial Institutions [*guoyou qiye jianshihui zhanxing tiaoli, guoyou zhongdian jinrong jigou jianshihui zhanxing tiaoli fabu*]', *People's Daily (Overseas Edition)*, 1 (March 22, 2000).
- _____, *A History of Chinese Currency [zhongguo huobi shi]* (1983).
- Xinwen, 'An Significant Reform of the PBOC Organizational System [*zhongyan yinhang guanli tizhi de zhongda gaige*]', *China Finance (Beijing)* No. 11, 82 (November 1998).
- Xu, Fei, 'The Development Road of Commercial Banks', *Jingrong Shibao (Beijing)*, 6 (April 15, 1996).
- Xue, Fei & Yang, Bin, 'Press Conference on China's Financial Situation Held by the First Session of the Ninth National People's Congress [*Shidang zhengjia huobi gongyingliang, baochi guoji shouji pingheng*]', *People's Daily (Overseas Edition)*, 2 (March 9, 1998).
- Xv, Jingyong, 'Causes to the Deterioration of the Asset Quality of State Specialized Banks', *Dangdai Jingji Yanjiu (Beijing)* No. 1 (1996).
- Xv, Nuojin, 'Three Theoretical Issues on China's Economic Reform [*woguo jingji gaige zhong de sange renshi wenti*]', *Jinrong Shibao*, 1 (July 3, 1999).
- Xv, Xingtang, 'The PBOC New Branch System Will Start on January 1, 1999 [*zhongguo renmin yanhang xin guanli tizhi 1999 nian 1 yue 1 ri kaishi yunxing*]', *People's Daily (Overseas Edition)*, 4 (December 31, 1998).
- Yang, Shaoping, Jiang, Yanfeng & Zhang Chaoyang, 'Suggestion for Credit-Risk Assessing and Prevention [*fangfan he huajie xingdai fengxian de duiche jianyi*]', *China Finance (Beijing)* No. 11, 23 (November 1999).
- Yao, Zhengyan (Governor of the State Development Bank of China), 'SDB in its Way to a Policy Bank With Chinese Characteristics', *China Finance (Beijing)* No. 3, 4 (1998).
- Ye, Hongyan, 'Recognizing the Current Crisis of Bad Loans in China's Financial Structure', *Ta Kung Bao (Hong Kong)* (January 20, 1998).
- Yi, Gang, *Money, Banking, and Financial Markets In China*, 27 (Beijing' 1994).
- _____, 'The Asset Structure of China's Financial Institutions and Its Policy Implication', *Jingji Yanjiu (Beijing)* No. 12 (1996).
- Yu, Jian & Wang, Jianmin, 'On Legal Infrastructure for Securitization [*lun zhichan zhengquanhua de fagui jianguan*]', *Journal of Finance* No. 2, 52 (1999).
- Yu, Jian, 'The Predicament and the Solution for State-Owned Enterprises', *Jingrong Shibao (Beijing)*, 1 (September 6, 1996).

- Yu, Liangchun, Jv, Yuan, 'Monopoly and Competition: Banking Monopoly and Competition in China [*rongduan yu jingzheng: zhongguo yinghang ye de gaige yu fanzhan*], *Economic Research Journal* No. 8, 48 (1999).
- Yu, Yongding, Zheng, Bingwen & Song, Hongren, *China After WTO Entry* (The Social Sciences Archive Publishing House, 2000).
- Yuan, Gangming, 'Empirical Analyses on China SOEs' Bad Debts [*zhongguo guoyu qiye buliang fuzhai de shizheng fengxi*]', *Economic Research Journal* No. 12, 12 (2000).
- Yuan, Guang, 'BOC Shares the Refulgence China Achieved in the Reform and Opening up', *China Finance (Beijing)* No. 8, 7 (1998).
- Yuan, Guanhua, 'Uniform Credit Authorizing System: the Check of Credit Risk [*tongyi shouxin zhidu: xindaifengxian de kongzhiqi*]', *China Finance (Beijing)* No. 9, 28 (1999).
- Zhan, Xiang-yan, 'ICBC's NPLs and Its Workout' in Policy Study Office of PBOC, *Issues on Bank and Enterprise Debt Restructuring*, 28 (Beijing 1995).
- Zhang, Chunlin, 'How to Appraise the Sustainability of Government Debt in China? [*ruhe pinggu woguo zhenfu zhaiwu de ke chixxing*]', *Economic Research Journal [jingji yanjiu]* No. 2, 66 (February 2000).
- _____, 'On SOEs' Debt Problem', in Wu, Tianlin (ed.), *Theory and Practices of State Sector Debt Restructuring [guoyou jingji zhaiwu chongzhu lilun yu shiwu]*, 96 (1997).
- Zhang, Haining & Ouyan, Haijie, 'How Can State Commercial Banks Prevent Credit Risks [*guoyou shangye yinhang fangfan xingdai fenxiang de chulv zai nali*? ', *China Finance (Beijing)* No. 10, 34 (1999).
- Zhang, Qingshou, 'Concentrate Funds, Promote Economic Development', *China Finance (Beijing)* No. 9, 10 (September 1994).
- Zhao, Haikuan, 'Asian Financial Crisis and China's Financial Situation', *China Finance (Beijing)* No. 1, 22 (1999).
- _____, 'The State Commercial Banks Should Be Converted into Joint Stock Banks [*guoyou shangye yinhang yiyu shixing gufengzhi*]', *China Finance (Beijing)* No. 11, 26 (November 1999).
- Zhao, Wenjie & Wang, Jianxin, 'A Discussion of Central Bank Supervision of Bank Asset Risk', *China Finance (Beijing)* No. 10, 30 (October 1994).
- Zhao, Yining, 'The Financial Situation and Financial Reform', *Liangwang (Outlook)*, 12-3 (May 15, 1995).
- Zhou, Rongfan & Chao, Deyun, 'The Reform and Development of China's Floating Interest Rate System' [*woguo fudong lilv zhidu de gaige he fazhan*]', *China Finance* No. 10, 23 (1998).
- Zhou, Rongfang, 'Rate Cut by PBOC Aimed at Stimulate Domestic Demand [*yanhang zhaichi jiangxi, jichi kuodai neixv*]', *China Finance* No. 7, 8 (July 1999).
- Zhou, Tianyong, 'The Feasibility of Debt Restructuring During the Ninth Five-Year Plan', *Gaige (Beijing)* No. 5, 30-36 (September 1995).

- _____, 'Deep Obstruction of General Demand Shrinkage and Its Way of Expansion [zhong xvqiu weishuo de shencheng genzhu jiqi kuozhang tujing]', *Economic Research Journal* No. 1, 9(January 1999).
- _____, 'The Transfer Mechanism of Debt-to-Equity Swap Programme and the Operation Risk [zhaizhuanggu de liucheng jili yu yunxing fengxian]', *Jingji Yanjiu [Economic Research Journal]* No. 1, 22 (January 2000).
- Zhou, Xiaochuan, 'The Restructuring of Bank-Enterprise Relationships [qiye yu yinhang guanxi de chongjian]', *Gaige [Reform]* No. 6 (June 1993).
- Zhou, Zhengqing, 'Securities Market Matures in Promoting Reform and Development [zhengquan shichang zai tuijin gegai he jingji jianshe zhong guifang fanzhang]', *China Finance (Beijing)* No. 10, 8 (October 1999).
- Zhu, Jianghong, 'Stock Cooperative System Should Be Promoted', *People's Daily (Beijing)*, 2 (August 8, 1997).
- Zhu, Ming & Huang, Jinlao, 'On China's Assets Management Corporations [lun zhongguo de zichan guanli gongsi]', *Economic Research Journal* No. 12, 3 (December 1999).
- Zhu, Yuanliang (Governor of the Agricultural Development Bank of China), 'Shenhua Gaige, Qianghua Guanli, Lizheng Shougou Zhijin Fenbi Yunxing Qvde Tupoxing Jingzhang', *China Finance (Beijing)* No. 2, 9 (1998).

II. BOOKS IN ENGLISH

- Aspinwall, Richard C. & Eisenbeis Robert A. (eds.), *Handbook for Banking Strategy* (1985).
- Bagehot, W., *Lombard Street* (1873).
- Baka, Wladyslaw, *Reform and Development Within Poland's Banking System*, IEF Research Papers in Banking and Finance 97/5 (1997).
- Baumol, William J., *Welfare Economics and the Theory of the State* (1965).
- Baums Theodor & Wymmeersch Eddy (eds.), *Asset-Backed Securitization in Europe* (1996).
- Beattie, Vivien A., et al., *Banks and Bad Debts: Accounting for Loan Losses in International Banking* (1995).
- Benston, George J., Eisenbeis, Robert A, Horvitz, Paul M., Kane, Edward J. & Kaufman, George G., *Perspectives on Safe and Sound Banking: Past, Present and Future* (1986).
- Bishop, Graham, Dirk Damrau & Michelle Miller, *1992 and Beyond: Market Discipline CAN Work in the EC Monetary Union* (1992).
- Bowles Paul & White, Gordon, *The Political Economy of China's Financial Reforms: Finance in Late Development* (1993).
- Buchanan, James & Tullock, Gorden, *The Calculus of Consent: Logical Foundations of Constitutional Democracy* (1962).

- Buckle Mike & Thompson, John, *The UK Financial System: Theory and Practice* (1995).
- Byrd, William A., *China's Financial System: The Changing Role of Banks* (1983).
- Caouette, J.B., E.I. Altman & Narayanan P., *Managing Credit Risk: The Next Great Financial Challenge*, (1998).
- Cecil Dipchang, Zhang Yichun & Ma Mingjia, *Chinese Financial System* (1994).
- Chai, Joseph C. H., *China: Transition to A Market Economy* (1997).
- Dale, Richard, *Bank Supervision around the World*, New York: Group of 30 (1982).
- Dewatripont, Mathias & Tirole, Jean, *The Prudential Regulation of Banks* (1994).
- Donald Moggridge (ed.), *The Collected Writings of John Maynard Keynes, Vol xxiv, Activities 1944-1946, the Transition to Peace* (1979).
- Edwards, Jeremy & Fischer, Klaus, *Banks, Finance and Investment in Germany* (1994).
- Epstein, David G., *Bankruptcy and Other Debt-Creditor Laws (5th edition)* (1995).
- Folkerts-Landau, David & Lindgren, Carl-Johan, *Toward a Framework for Financial Stability* (1998).
- Gardner, Richard N., *Sterling-Dollar Diplomacy in Current Perspective* (1980).
- Girardin, Eric, *Banking Sector Reform and Credit Control in China* (1997).
- Goodhart, Charles A., *The Central Bank and the Financial System* (1995).
- Goodhart, Charles, *et al.*, *Financial Regulation: Why, How and Where Now?* (1998).
- Hadjiemmanuil, Christos, *Banking Regulation and the Bank of England* (1996).
- Harif, William S. & Kushmeider, Rose Marie (eds.), *Restructuring Banking & Financial Services in America* (1988).
- Hayek, Friedrich A., *Collectivist Economic Planning* (1935).
- Hilton, Andrew, *Debt /Equity Swaps: Costs, Benefits and Prospects* (1988).
- Holz, Carsten, *The Role of Central Banking in China's Economic Reform* (1992).
- Hubbard, G., *Money, the Financial System and the Economy* (1994).
- Hudec, Robert E., *Enforcing International Trade Law: The Evolution of The Modern GATT Legal System* (1993).
- Jackson, John H., *The World Trading System* (1989).
- Jacobson, Harold & Oksenberg, Michael, *China's Participation in the IMF, the World Bank, and GATT* (1990).
- Jasay, A. de, *Market Socialism: a Scrutiny. 'This Square Circle'* (1990).
- Jesee, Michael A. & Seelig, Steven A., *Banking Holding Companies and the Public Interest: an Economic Analysis* (1977).
- Jin, Leroy, *Monetary Policy and the Design of Financial Institutions in China, 1978-1990* (1994).

- Kaletsky, Anatole, *The Cost of Default, a Twentieth Century Fund Paper* (1985).
- Kane, Edward J., *The Gathering Crisis in Federal Deposit Insurance* (1986).
- _____, *The Gathering Crisis in Deposit Insurance* (1985).
- Keynes J. M., *The General Theory of Employment, Interest and Money* (1936).
- Kinsella, Ray (ed.), *Internal Controls in Banking* (1995).
- Kornai, Janos, *Highway and Byways* (1995).
- _____, *The Socialist System: The Political Economy of Communism* (1992).
- _____, *Vision and Reality, Market and State* (1990).
- _____, *Contradictions and Dilemmas* (1986).
- _____, *Growth, Shortage and Efficiency* (1982).
- _____, *Economics of Shortage* (1980).
- Lardy, Nicholas R., *China's Unfinished Economic Revolution* (1998).
- _____, *Agriculture in China's Modern Economic Development* (1983).
- Lastra, Rosa Maria, *Central Banking and Banking Regulation* (1996).
- Lavoie, Don., *Rivalry and Central Planning: the Socialist Calculation Debate Reconsidered* (1985).
- Lees, Francis A. & Liaw, K. Thomas, *Foreign Participation in China's Banking and Securities Market* (1996).
- Ligeti, Sandor, *Problem Loans*, 17, IEF Research Papers in Banking and Finance 93/13 (1993).
- Macey, J. & Miller, G., *Banking Law and Regulation* (1992).
- Maisel, Sherman J. (ed.), *Risk and Capital Adequacy in Commercial Banks* (1981).
- Mason, Edward S. & Asher, Robert E., *The World Bank Since Bretton Woods* (1973).
- Mayer, Colin & Vives, Xavier (eds.), *Capital Markets and Financial Intermediation* (1993).
- Mehran, Hassanali, Laurens, Bernard & Quintyn Marc (eds.), *Interest Rate Liberalization and Money Market Development* (1996).
- Naughton, Barry, *Growing out of the Plan: Chinese Economic Reform 1978- 1993* (1995).
- Niskanen, William A., *Bureaucracy and Representative Government* (1971).
- Norton, J. J. (ed.), *Prospects for Int'l Lending and Rescheduling* (1988).
- Norton, J. J., *Devising International Bank Supervisory Standards* (1995).
- Semkow, Brian W. (ed.), *China Finance Manual* (1995).
- Sheng, Andrew, *Bank Restructuring: Lessons from the 1980s*, 32 (1996).
- Smith, R. C. & Walter, I., *Global Banking* (1997).
- Stiglitz, Joseph E., et al., *The Economic Role of the State* (1989).
- Sundararajan V. & Balino T. (eds.), *Banking Crises, Cases and Issues* (IMF 1991).

- Tam, On Kit (ed.), *Financial Reform in China* (1995).
- The PBOC, *China Financial Outlook 1996* (Beijing: 1998).
- _____, *China Financial Outlook 1998* (Beijing: 1996).
- Tokley, I. A. & Ravn, Tina, *Banking Law in China* (1997).
- Wan, Timothy Haosen, *Development of Banking Law in the Great China Area: PRC and Taiwan* (1999).
- Winham, Gilbert, *The Evolution of International Trade Agreements* (1992).
- Wood Philip R., *Title Finance, Derivatives, Securitizations, Set-off and Netting* (1995).
- Wu, Jinglian, *et al.*, *The Road to a Market Economy: A Comprehensive Framework and Working Proposals* (1995).

III. ARTICLES AND BOOK CHAPTERS IN ENGLISH

- Abrahams, Paul, 'Hitachi May Close Failing Division', *Fin. Times* (April 3, 1999).
- _____, 'Mistubishi Electric: Radical Talk', *Fin. Times* (April 1, 1999).
- _____, 'Mitsubishi Electric Launches Shake-up', *Fin. Times* (April 1, 1999).
- Abrahams, Paul & Peel, Michael, 'Receiver to Sue Yamaichi Auditor', *Fin. Times* (December 15, 1999).
- American Banker, 'Silver Lining in Thai Auction', *2 Asset Sales Report International* No. 7, 1 (April 5, 1999).
- Andrew, Sheng, 'The Framework for Financial Supervision: Macro and Micro Issues' in *Strengthening the Banking System in China: Issues and Experience*, BIS Policy Papers No. 7, 154 (October 1999).
- _____, 'Resolution and Reform: Supervisory Remedies for Problem Banks' in Andrew, Sheng (ed.), *Bank Restructuring: Lessons from the 1980s*, 51 (1996).
- AsianWeek, 'The Asianweek Financial 500: A New Breed Rising' (September 10, 1999), available at '1999 WL 7759661).
- AsiaPort Daily News, 'New Loan Procedure Supports Exports' (September 2, 1999), available at '1999 WL 22634372'.
- Aslund, Anders, 'When a Banking Crisis Is a Good Thing', *Fin. Times* (September 13, 1995).
- Atkinson, Dan, 'China Plans Bank Clean-up as Yuan Slides', *The Guardian (London)* 17 (April 6, 1999).
- Baker, Gerard, 'Insurance Fees to Leap for Banks in Japan', *Fin. Times* (December 23, 1995).
- Bangkok Post, 'In Brief: Restructured Loan Totals at B280bn' (May 12, 1999), available at '1999 WL 17689444'.

- Bangkok Post, 'Tarrin Agrees to Review August 14 Plan: Rules out Taxpayers Footing the NPL Bill' (March 25, 1999).
- Barale, Lucille, 'China's New Securities Law: A Closer Look', in Norton, Joseph J. & Andenas, Mads (eds.), *Emerging Financial Markets and Secured Transitions* (1998).
- Bardacke, Ted, 'Thailand: Liquidations Raise Bt255bn', *Fin. Times* (December 16, 1999).
- _____, 'Bangkok Puts IMF's \$3bn on Hold', *Fin. Times* (September 21, 1999).
- _____, 'Nakornthon: Standard Chartered Gets Free Reign', *Fin. Times* (September 14, 1999).
- _____, 'Thai Farmers Bank: Group Pulls out from Phatra', *Fin. Times* (August 31, 1999).
- _____, 'Thai Oil: Debt Plan Wins Approval', *Fin. Times* (August 25, 1999).
- _____, 'Siam Commercial Raises \$1.75bn', *Fin. Times* (April 30, 1999).
- _____, 'Alphatec: Thai Rescue Shows Way', *Fin. Times* (March 5, 1999).
- _____, 'Thailand: Debt Makes up 44% of Lending', *Fin. Times* (March 3, 1999).
- _____, 'Thailand: Banks Post Big Losses', *Fin. Times* (January 25, 1999).
- _____, 'Thailand: Bank Sell-offs Get Under Way', *Fin. Times* (February 3, 1999).
- _____, 'Thailand: Assets Auction Resumes Next Month', *Fin. Times* (January 22, 1999).
- _____, 'Thailand: Provisions Push Banks Deep into Loss', *Fin. Times* (January 22, 1999).
- _____, 'Thailand: Debt Restructuring Bolsters Loans Portfolio', *Fin. Times* (January 1, 2000).
- Barnes, William, 'Thailand: Slowdown over Banks Looms', *Fin. Times* (November 24, 1999).
- _____, 'Recovering Banks off the Danger List', *Fin. Times* (November 9, 1999).
- _____, 'Thai Oil: Creditors Agree \$2.2bn Debt Deal', *Fin. Times* (October 23, 1999).
- _____, 'Thai Bank Taken on Despite Bad Debts', *Fin. Times* (October 7, 1999).
- _____, 'German Lender Swaps Debt for TelecomAsia Stake', *Fin. Times* (October 2, 1999).
- _____, 'Thai Company Shelves \$645m IPO', *Fin. Times* (September 27, 1999).
- _____, 'Radanasin: Bangkok to Keep Stake in Bank', *Fin. Times* (March 17, 1999).
- _____, 'Thailand: Banks Try Unusual Issues', *Fin. Times* (March 2, 1999).
- Barrow, Martin, 'Eurotunnel Debt Plan under Way', *Times* (April 4, 1998).
- Barth, James R. & Brumbaugh, R. Dan Jr., 'Savings & Loan Crisis: Lessons and a Look Ahead: The Rough Road From FIRREA to Deposit Insurance Reform', 2 *Stan. L. & Policy Rev.* 58 (Spring, 1990).
- Batchelor, Charles, 'Eurotunnel: Channel Tunnel Operator to Buy back Debt', *Fin. Times* (September 30, 1999).
- Bator, Francis M., 'The Anatomy of Market Failure', 72 *Quarterly Journal of Economics* 3, 351 (1958).

- Baums, Theodor, 'The German Banking System and Its Impact on Corporate Finance and Governance', in Aoki, Masahiko & Patrick, Hume (eds.), *The Japanese Main Bank System*, 409-449 (1994).
- Begg, David & Portes R., 'Enterprise Debt and Economic Transformation: Financial Restructuring in Central and Eastern Europe', in Mayer C and Vives X (eds.), *Capital Markets and Financial Intermediation* (1993).
- Benson, George J., 'Federal Regulation of Banking: Analysis and Policy Recommendations', *Journal of Banking Research* 216 (Winter 1983).
- Benson, Todd, R., 'Taking Security in China: Approaching U.S. Practices?' 21 *Yale J. Int'l L.*, 183 (1996).
- Benston, George J., 'Deposit Insurance and Bank Failures', *Federal Reserve Bank of Atlanta Economic Review* 4 (March 1983).
- _____, 'Interest Payments on Demand Deposits and Bank Investment Behavior', 72 *Journal of Political Economy* 431 (October 1964).
- Benston, George J. & Kaufman, George G., 'Regulating Bank Safety and Performance', in Harif, William S. & Kushmeider, Rose Marie (eds.), *Restructuring Banking & Financial Services in America* (1988).
- Bergson, Abram, 'Market Socialism Revisited', 75 *Journal of Political Economy* No.5, 655 (October 1967).
- _____, 'Socialist Economics', in Ellis, Howard S. (ed.), *A Survey of Contemporary Economics* (1948).
- Birchall, Jonathan, 'Malaysia: Assets Sale Launched', *Fin. Times* (November 19, 1999).
- _____, 'Banks Sign 'Anchor' Agreements', *Fin. Times* (October 1, 1999).
- _____, 'Malaysia: Difficult Path to Banking Reform', *Fin. Times* (September 30, 1999).
- _____, 'Maybank: Improvement Reflects Malaysia Recovery', *Fin. Times* (September 9, 1999).
- Blejer, Mario I. & Gyorgy Szapary, 'The Evolving Role of Tax Policy in China', 14 *Journal of Comparative Economics* No. 3 452 (September 1990).
- Bloomberg, 'Banks OK Eurotunnel Debt Restructuring', *The Financial Post* (January 31, 1998).
- Boland, Vincent & Montagnon, Peter, 'KEB: New Issue Put on Hold', *Fin. Times* (October 6, 1999).
- Boshkoff, Douglas G. & Song, Yongxin, 'China's New Bankruptcy Law: A Translation and Brief Introduction', 61 *Am. Bankr. L. J.* 359 (Fall 1987).
- Bowles, Paul & Gordon White, 'Contradictions in China's Financial Reforms: The Relationship between Banks and Enterprises', 13 *Cambridge Journal of Economics* No. 4 481 (December 1989).
- Brainarde, Lary, 'Reform in Eastern Europe: Creating a Capital Market', 17 *The AMEX Bank Review* No. 9, 2-3 (November 8, 1990).

- Brown-Humes, Christopher & Harney, Alexandra, 'Mitsubishi and Volvo Strike Strategic Deal', *Fin. Times* (October 9, 1999).
- Burke, Michael E., IV, 'Improving China's Bank Regulation to Avoid the Asian Bank Contagion', 17 *UCLA Pac. Basin L. J.*, 32 (Summer 1999).
- Burton, John & Lucas, Louise, 'SeoulBank: S Korea to Inject Funds after Sale Collapsed', *Fin. Times* (September 1, 1999).
- Burton, John & Montagnon, Peter, 'Seoulbank: Foreign Buyers Uninterested', *Fin. Times* (December 4, 1999).
- Burton, John, 'S Korea Signals End of Economic Crisis', *Fin. Times* (November 23, 1999).
- _____, 'Daewoo: ITCs Receive Aid to Cushion Solvency Fears', *Fin. Times* (November 1, 1999).
- _____, 'Hyundai: Chaebol Moves to Reassure Investors', *Fin. Times* (October 26, 1999).
- _____, 'Daewoo: Banks to Manage Debt-Restructuring Companies', *Fin. Times* (September 4, 1999).
- _____, 'Daewoo: Financial Ties Cut Between Units', *Fin. Times* (August 31, 1999).
- _____, 'Daewoo: Impatient Creditors Take Control', *Fin. Times* (August 27, 1999).
- _____, 'S Korea: Seoul Vows to Curb "Chaebols"', *Fin. Times* (August 26, 1999).
- _____, 'Curbs Planned on Chaebol Financing', *Fin. Times* (August 19, 1999).
- _____, 'S Korea: Seoul Threatens Industry Giant', *Fin. Times* (April 28, 1999).
- _____, 'Hyundai to Pay \$2.1bn for LG Semicon', *Fin. Times* (April 24, 1999).
- _____, 'Hyundai, Daewoo Announce Restructuring', *Fin. Times* (April 20, 1999).
- _____, 'Daewoo: Shipbuilding Interest on Market', *Fin. Times* (April 20, 1999).
- _____, 'Daewoo Plans to Halve \$49bn Debts', *Fin. Times* (April 19, 1999).
- _____, 'Korea First: Bank Takeover Impasse', *Fin. Times* (April 13, 1999).
- _____, 'Top Five Chaebol's Debt Burden Soars', *Fin. Times* (April 7, 1999).
- _____, 'South Korea: Hyundai, Daewoo to Submit New Plans', *Fin. Times* (March 31, 1999).
- _____, 'Daewoo Knocks S Korea Banks', *Fin. Times* (March 3, 2000).
- _____, 'South Korea's Chaebol Agree Link-up', *Fin. Times* (December 8, 1998).
- _____, 'Chaebol: Samsung and SK Top of the Class', *Fin. Times* (December 8, 1998).
- _____, 'S Korea: Banks Return to the Black', *Fin. Times* (August 18, 1998).
- Cai, E-sheng, 'Financial Supervision in China: Framework, Methods and Current Issues' in *Strengthening the Banking System in China: Issues and Experience*, BIS Policy Papers No. 7, 169 (October 1999).
- Callick, Rowan, 'China Draws Near to WTO Membership', *Australia Financial Review* 15 (April 28, 1999).

- Calomiris C. W. & Kahn, C. M., 'The Role of Demandable Debt in Structuring Optimal Banking Arrangements', 81 *American Economic Review* 497 (1993).
- Campbell, Neil, 'Securitisation a Viable Option', *South China Morning Post* (March 11, 1999).
- Chai, J. C. H., 'Domestic Money and Banking Reform in China', *Hong Kong Economic Papers*, No. 14, 37 (1981).
- _____, 'Bankruptcy Law in China: too Much or too Little?' 13 *China Law and Practices* No. 5, 22-25 (June/July 1999).
- _____, 'Rethinking China's Bank Bailout', *The Asian Wall St. J.* 8 (April 7, 1999).
- _____, 'Gitic's Failure Puts Untested Bankruptcy Law in Focus', *South China Morning Post* (March 11, 1999).
- Chang, Hsin, 'The 1982-83 Over-investment Crisis in China', 24 *Asian Survey* No. 12, 1277 (December 1984).
- Chang, TK, 'The Easter Is in the Red', *International Financial Law Review*, 43 (March, 1999).
- Charmichael, Jeffrey, 'The Framework for Financial Supervision: Macro and Micro Issues' in *Strengthening the Banking System in China: Issues and Experience*, BIS Policy Papers No. 7, 141 (October 1999).
- Chen, Feng, 'Chinese Bankruptcy Law: Milestones and Challenges', 31 *St. Mary's Law Journal* 1, 49 (1999).
- Chen, Gretchen Harders, 'China MFN: A Reaffirmation of Tradition or Regulatory Reform', 5 *Minn. J. Global Trade* 381 (Summer, 1996).
- Chen, Kathy, 'China to Restructure Central Banks, Plans Panel to Guide Finance Policy', *Wall Street Journal* (April 7, 1998).
- Chen, Shu-Ching Jean, 'Taiwan: Chiao Tung Bank is Privatized', *Fin. Times* (September 13, 1999).
- China Daily, 'China: Debt-equity Swap Agreement Reached' (December 11, 1999), available at '1999 WL 30608393'.
- _____, 'China: Bank Set to Support Industry Restructuring' (December 7, 1999).
- _____, 'China: Big Move in Debt-Equity Swap' (December 3, 1999).
- _____, 'China: Chronology of China's WTO Accession' (November 16, 1999).
- _____, 'China: Substantial Act Needed to Boost Banking Reform' (November 8, 1999).
- _____, 'China: Sound Credit Structure Needed' (October 24, 1999).
- _____, 'China: AMCs Enhance Financial System' (October 24, 1999).
- _____, 'China: Asset Company to Manage Bad ICBC Loans' (October 20, 1999), available at '1999 WL 17782996'.
- _____, 'China: New Company to Handle Assets' (October 19, 1999), available at '1999 WL 17782977'.

- ____, 'China: State Enterprise Reform Reviewed' (September 22, 1999).
- ____, 'China: Deal to Turn around Steel Giant' (September 18, 1999).
- ____, 'China: State Banks to Receive Extra Help on Bad Loans' (May 4, 1999), *available at '1999 WL 17779246'*.
- ____, 'China: People's Bank Issues Guidance for Credit' (May 4, 1999).
- ____, 'China: Loans Help Enterprises Staunch Flow of Red Ink' (April 25, 1999).
- ____, 'China: Firm Set up to Manage Assets' (April 21, 1999), *available at '1999 WL 5969010'*.
- ____, 'China: Monetary Policies Important' (April 20, 1999), *available at '1999 WL 5968968'*.
- ____, 'China: Individuals Made Home Loan Target' (April 11, 1999), *available at '1999 WL 5968854'*.
- ____, 'China: China Money Market to Grow' (April 11, 1999), *available at '1999 WL 5968842'*.
- ____, 'China: Dilatory Debtors Face Stricter Sanctions' (March 14, 1999).
- ____, 'Housing Reform: Q & A' (June 18, 1998).
- ____, 'Adieu to Welfare Housing- Reform Project Revealed' (June 18, 1998).
- ____, 'Bright and Secure' (May 27, 1996).
- ____, 'Property Rights Must Be Defined' (January 27, 1996), *available in Lexis, World Library, Txtlne file.*
- Chongmakapat, Teerana, 'Thailand Moves into Recovery Mode', *Nation (Thailand)* (December 2, 1999).
- Choy, Gilbert C., 'Keynes Fails in China . . .', *Asian Wall St. J.*, 10 (December 16, 1999).
- Chu, Vivian, 'China Starts Long March to Securitization', *Emerging Mkts Debt Rep.* (March 6, 2000), *available at '2000 WL 3958353'*.
- Chuensuksawadi, Pichai & Ingsrisawang, Cholada, 'Non-Performing Loans: DBS Happy with Thai Danu's Pace of Reform: "New Bankruptcy Law is Positive"', *Bangkok Post* (March 30, 1999), *available at '1999 WL 8496796'*.
- Claessens, Stijin, 'Experiences of Resolution of Banking Crises' in *Strengthening the Banking System in China: Issues and Experience*, BIS Policy Papers No. 7, 275 (October 1999).
- Clark, Donald C., 'State Council Notice Nullifies Statutory Rights of Creditors', 19 No. 4E. *Asian Executive Rep.* 9 (April 15, 1997).
- Clarotti, Paolo, 'Legislation Related to Bank Insolvency in the European Union' in Lastra, R. M., Schiffman, Henry N. (eds.), *Bank Failures and Bank Insolvency Law in Economies in Transition*, 311 (1999).
- Clifford, Mark L. & Sharl Michael, 'Remarking Singapore Inc.', *Business Week* 19 (April 5, 1999).

- Cline, William, 'Mobilizing Bank Lending to Debtor Countries', 18 *Policy Analyses in International Economics* 1 (1987).
- Coe, Linda B., 'Abrogation of Forbearance Agreements: Unauthorized by FIRREA and Unconstitutional', 59 *GEO. Wash. L. Rev* 157, 158 (1990).
- Corzine, Robert, 'Hyundai Oil: Abu Dhabi Buys Stake in South Korean Oil Group', *Fin. Times* (October 21, 1999).
- Cox, Albert M. Jr., 'Regulation of Interest on Bank Deposits', 17 *Michigan Business Studies* No. 4.
- Crockett, A., 'The Future of Banking Regulation', *Euromoney*, 272-3 (September 1999).
- Dai, Xianglong, 'Opening Address' in *Strengthening the Banking System in China: Issues and Experience*, BIS Policy Papers No. 7 (October, 1999).
- Dichie, Mure, 'Taiwan to Form Debt Auction Institution', *Fin. Times* (November 30, 2000).
- _____, 'China: Government Launches Fresh Drive on Bad Loans', *Fin. Times* (October 18, 1999).
- _____, 'Taiwan: Bank Told to Take Over Co-Op', *Fin. Times* (September 17, 1999).
- Dillion, Thomas J. Jr., 'The World Trade Organization: A New Legal Order for World Trade?' 16 *Mich. J. Int'l L.* 349 (1995).
- Dince, Robert R., 'The Regulators Have a New Point of View', *Fortune* 166 (October 8, 1979).
- Dornbusch, Rudi & Giavazzi, Francesco, 'Heading off China's Financial Crisis' in *Strengthening the Banking System in China: Issues and Experience*, BIS Policy Papers No. 7, 40 (October 1999).
- Ebenroth, 'Innovations in LDC Debt Conversions', Comprising Chapter 3 in Norton, J. J. & Auerback R. (eds.), *International Finance in the 1990s: Challenges and Opportunities* (1993).
- Ehrlich, Craid P. & Lee, Jay K., 'Governance of Korea's Chaebols: Role in Crisis, Coming Changes', *East Asian Executive Reports* 9 (March 15, 1998).
- Faison, Seth, 'Seeking a Remedy for Its Industrial Woes, the Chinese Think Big', *International Herald Tribune*, 1, 5 (February 21-22, 1998).
- Felsenfeld, Carl, 'The Savings and Loan Crisis', 59 *Fordham L. Rev.* S7, S 28 (May 1991).
- Fernando, Montes-Negret, 'China's Credit Plan: An Overview', 11 *Oxford Rev. of Econ. Pol'y* No. 4, 25 (Winter 1995).
- Filder, Stephon, 'IMF Presses Asia on Corporate Reform', *Fin. Times* (December 5, 2000).
- _____, 'China/US: Concession Greater than Many Expected', *Fin. Times* (April 9, 1999).
- Financial Express (Bombay), 'China Develops Software to Curb Lending Risks' (April 17, 1999), available at '1999 WL 5533130'.
- Foo Choy Peng, 'New Bid to Hold Bad-Debt Rise', *South China Morning Post*, 4 (September 15, 1999).

- _____, 'Shanghai Pioneers Mortgage Securities Secondary Market Aims to Free Institutions for More Lending', *South China Morning Post*, 4 (May 14, 1999).
- _____, 'China Cinda Seeks Foreign Help', *South China Morning Post*, 8 (May 5, 1999).
- _____, 'Beijing Tackles Bad Loans-Asset Firms to Ease State Banks' Burden with Eye on WTO Entry', *South China Morning Post* 1 (April 27, 1999).
- Foust, Dean, 'The RTC's Epitaph: It Worked', *Bus. Wk.*, 29 (January 15, 1996).
- Friedman, Benjamin M., 'Financial Intermediation in the United States', in Aspinwall, Richard C. & Eisenbeis Robert A. (eds.), *Handbook for Banking Strategy* (1985).
- Friedman, Milton, 'Monetary Policy: Theory and Practice', 14 *Journal of Money, Credit and Banking* 98 (February 1982).
- Goodhart, C & Schoenmaker, D., *Institutional Separation between Supervisory and Monetary Agencies*, LSE Financial Market Group, Special Paper No. 52 (April 1993)
- Graham, George & Barnes, William, 'Thailand: Standard Chartered Set for 70% Stake in Nakornthon', *Fin. Times* (April 28, 1999).
- Graham, George, 'Standard Chartered Ends Bank Bali Deal', *Fin. Times* (December 16, 1999).
- _____, 'Finance: Banks Urged on Risk Management', *Fin. Times* (March 22, 1999).
- _____, 'Basle: Banks Unhappy at Risk Proposals', *Fin. Times* (March 5, 1999).
- Gu, Minkang, 'Acquisition of State-owned Shares through Chinese Securities Markets: A Way of Privatization?' *International Business Lawyer*, 386 (October 1999).
- Hagermand, Deano & Gajewski, Gregory, 'Patterns of Financial Institution Failures: Some Thoughts on Policy Implications', *Federal Deposit Insurance Corporation Banking and Economic Review* 8 (May/June 1987).
- Hall, William & Balls, Andrew, 'Banking: Consolidation Fails to Boost Profits', *Fin. Times* (August 23, 1999).
- Hamilton David P., 'Japanese Recession Forces Restructurings Even Bold Steps Look Unlikely to Bolster Corporate Profits', *The Wall Street Journal*, A15 (September 30, 1998).
- Harding James, 'China Plans Listing for Bank Shares', *Fin. Times* (September 30, 1999).
- _____, 'China: Bank Boosts Executive Pay', *Fin. Times* (September 28, 1999).
- _____, 'Shanghai: Development Bank Set for Offering', *Fin. Times* (September 23, 1999).
- _____, 'China Passes New Banking Law', *Fin. Times* (May 12, 1995).
- _____, 'China: Banks That Don't Know When to Stop', *Fin. Times* (May 5, 1999).
- _____, 'China Plans Savings Protection Scheme', *Fin. Times* (April 28, 1999).
- _____, 'Banking Reforms Part of China WTO Bid', *Fin. Times* (April 21, 1999).
- _____, 'China: Growth Remains Robust', *Fin. Times* (April 21, 1999).
- _____, 'China: Bad Loans Soar in Shenzhen', *Fin. Times* (April 17, 1999).

- ____, 'China: Exports Fall Adds to Strain', *Fin. Times* (April 13, 1999).
- ____, 'China: End of the Goldrush', *Fin. Times* (March 25, 1999).
- ____, 'China: Foreign Investment Slows', *Fin. Times* (March 25, 1999).
- ____, 'China: Forex Reserves Used to Help Banks', *Fin. Times* (March 24, 1999).
- ____, 'CCB: Chinese Bank Eyes New Securities', *Fin. Times* (March 23, 1999).
- ____, 'China Banks Sack Managers', *Fin. Times* (March 20, 1999).
- ____, 'China: Banks to Be Allowed to Price Risks', *Fin. Times* (March 12, 1999).
- ____, 'China Tackles Bad Management', *Fin. Times* (March 6, 1999).
- ____, 'Official Arrested over Chinese Fraud', *Fin. Times* (March 5, 1999).
- ____, 'China: Corruption May Threaten State', *Fin. Times* (March 5, 1999).
- ____, 'China: Financial Institution Downgraded', *Fin. Times* (March 2, 1999).
- ____, 'China: The Model of a Modern Banker', *Fin. Times* (February 17, 1999).
- ____, 'China: Foreign Banks Get Tough', *Fin. Time* (February 8, 1999).
- ____, 'China: Beijing Drafts Bankruptcy Laws', *Fin. Times* (February 5, 1999).
- ____, 'China: Five More Trust to Be Closed', *Fin. Times* (February 3, 1999).
- ____, 'China: Market Differences Emphasised', *Fin. Times* (January 28, 1999).
- ____, 'China: Gitic Failure Starts to Hurt other Businesses', *Fin. Times* (January 22, 1999).
- ____, 'China: Profits under Pressure', *Fin. Times* (January 22, 1999).
- ____, 'China: High Growth Rate "Lacks Quality"', *Fin. Times* (January 4, 1999).
- Harmer, Ronald Winston, 'Insolvency Law and Reform in the People's Republic of China', *64 Fordham L. Rev.* 2563 (May, 1996).
- Harmon, James A., 'Harmon-Rule and Prosper', *Fin. Times* (March 10, 1999).
- Harney, Alesandra & Tett, Gillian, 'Nissan, IBJ, Fuji Dispose of Stakes', *Fin. Times* (November 9, 1999).
- Harney, Alexandra & Abrahams, Paul, 'Nissan: "Killer" to Make Unkindest Cut', *Fin. Times* (October 18, 1999).
- Harney, Alexandra & Brown-Humes, Christopher, 'Mitsubishi: Motor Group to Cut 12,000 Jobs', *Fin. Times* (October 27, 1999).
- Harney, Alexandra, 'Volvo/Mitsubishi: Efficiency Drive', *Fin. Times* (October 9, 1999).
- ____, 'Nissan: Debt is \$2.2bn More than Disclosed', *Fin. Times* (March 30, 1999).
- Harris, Clay & S. K. Zainuddin in Jarkata, 'Standard Chartered: Landmark Bank Deal in Indonesia', *Fin. Times* (April 23, 1999).
- Hassany, Yasmin, 'Italian Securitization Law Boosts Banks', *Wall St. J. Eur.*, 25 (September 6, 1999).

- Hawkins, John & Turner Philip, 'Bank Restructuring in Practice: An Overview' in *Bank Restructuring in Practice*, 6, BIS Policy Papers No. 6 (August 1999).
- Herring, Richard J., & Vankudre, Prashant, 'Growth Opportunities and Risk-Taking by Financial Intermediaries', 42 *Journal of Finance* 583 (July 1987).
- Herring, Richard, J. 'The Economics of Workout Lending', 21 *Journal of Money, Credit, and Banking* No. 1, 1 (Feb. 1989).
- Holcombe, Cathy, 'Devaluation "Needed" for Struggling Banks', *South China Morning Post* 1 (March 25, 1999).
- Holmes, William D., 'China's Financial Reforms in the Global Market', 28 *Law & Pol'y Int'l Bus.* 715.
- Ibison, David, 'Japan's Bank Groups Launch', *Fin. Times* (April 1, 2001).
- _____, 'Bank Bali: Standard Chartered Faces Battle', *Fin. Times* (December 3, 1999).
- Ingsrisawang, Cholada, 'Opinion/Shaping a Better Banking Industry: Improved Fortune Allow Time to Rethink Sell-off', *Bangkok Post* 8 (December 8, 1999).
- _____, 'Bangkok Bank: New Rating System Will Help Borrowers Taking a More Systematic Approach, ...', *Bangkok Post* 1 (December 7, 1999).
- _____, 'Corporate Debt; B629bn of Loans Restructured', *Bangkok Post*, 10 (September 2, 1999).
- _____, 'Bangkok Bank Issues Its Caps: B40bn of Securities Released Today', *Bangkok Post* (March 19, 1999), available at 1999 WL 8496018.
- Ingves, Stefan, 'Lessons of Bank Restructuring from the Asian Crisis — A Commentary', *The Strait Times (Singapore)* (September 30, 1999).
- Iyer, Savita, 'China Plans AMCs for Bank Rescue', 12 *American Banker* No. 13, 1 (March 29, 1999).
- Jacob, Rahul & Lucas, Louise, 'China: Government Details Citic Assets', *Fin. Times* (April 23, 1999).
- Jacob, Rahul, 'Banking: Prepared to Stay in Black', *Fin. Times* (March 30, 1999).
- _____, 'China: Citic Pacific Chief Urges Caution', *Fin. Times* (March 30, 1999).
- Jakarta Post, 'Government to Sign New Letter of Intent with IMF' (May 14, 1999), available at '1999 WL 5635281'.
- _____, 'Government to Recapitalize 12 Provincial Banks' (May 8, 1999), available at '1999 WL 5635172'.
- _____, 'IBRA Returns Bad Loans to State Bank Management' (May 8, 1999), available at '1999 WL 5635173'.
- James, Christopher, 'The Losses Realized in Bank Failure', 46 *The Journal of Finance* No.4, 1223 (September 1991).
- James Kynge, 'China: Beijing Plans fresh Drive on Technology', *Fin. Times* (January 29, 1999).

- Jiwamol Kanokslip, 'Light at End of the Tunnel, Thanks to Tier-1 Support Scheme' *Nation* (May 4, 1999), available at '1999 WL 15653396'.
- Johnson, Ian, 'Asset Managers in China Strain to Save Banks', *Wall St. J.*, A33 (November 8, 1999).
- Jonquieres, Guy & Kynge, James, 'China: Beijing's Big Gamble', *Fin. Times* (November 16, 1999).
- Kane, Edward J. 'Appearance and Reality in Deposit, the Case for Reform', 10 *Journal of Banking and Finance* 175 (1986).
- _____, 'Metamorphosis in Financial Services Delivery and Production', in Federal Home Loan Bank of San Francisco, *Strategic Planning for Economic and Technological Change in the Financial Services Industry* (1983).
- _____, 'Accelerating Inflation, Technological Innovation, and the Decreasing Effectiveness of Banking Regulation', 36 *Journal of Finance* 355 (May 1981).
- _____, 'Good Intentions and Unintended Evil: The Case against Selective Credit Allocation', 9 *Journal of Money, Credit and Banking* 55 (February 1977).
- Kaufman, G. G., 'The Securities Activities of Commercial Banks', in Aspinwall, Richard C. & Eisenbeis Robert A. (eds.), *Handbook for Banking Strategy* (1985).
- Kawalec, Stefan, Sikora, S & Rymaszewski, P, 'Dealing With Bad Debts: The Case of Poland', in Caprio, Gerard, D Fokerts-Landau and Lane, T D, *Building Sound Finance in Emerging Market Economies* (IMF 1994).
- Kazmin, Amy, 'Thais Unveil Private Bank Debt Deal', *Fin. Times* (March 9, 2001).
- _____, 'Bangkok to Buy Banks' Bad Debts', *Fin. Times* (February 25, 2001)
- Keenan, Faith, 'Driving out the Debt', *Far E. Econ. Rev.*, 84 (September 9, 1999).
- Kelly, Jim, 'Investing: Insolvency Laws Must be Given US-Style Shake-up', *Fin. Times* (April 26, 1999).
- Kennedy, Kevin C., 'The GATT-WTO System at Fifty', 16 *Wis. Int'l L. J.* 421 (Summer 1998).
- Ketcha, Nicholas J Jr., 'Deposit Insurance System Design and Considerations' in *Strengthening the Banking System in China: Issues and Experience*, BIS Policy Papers No. 7, 221 (October 1999).
- Kim, S.B. & Moreno, R., 'Stock Prices and Bank Lending Behavior in Japan', *Economic Review* No. 1, 31 (Federal Reserve Bank of San Francisco, 1994).
- King, Mervyn & Goodhart, Charles, *Financial Stability and the Lender of the Last Resort Function: A Note*, LSE Financial Markets Group Special Paper (July 1994).
- King, Robert G. & Levine, Ross, 'Finance and Growth: Schumpeter Might Be Right', 53 *Quarterly Journal of Economics* 715-37 (August 1993).

- King, Robert G. & Levine, Ross, 'Financial Intermediation and Economic Development', in Mayer, Colin & Vives, Xavier (eds.), *Capital Markets and Financial Intermediation* (1993).
- Kiyotaki, Nobuhiro & Moore, John, 'Credit Cycles', 105 *Journal of Political Economy* No. 2, 211 (1997).
- Kong, Kevin T.S., 'Prospects for Asset Securitization within China's Legal Framework: the Two-Tiered Model', 32 *Cornell Int'l L.J.* 237 (1998).
- Korea Economic Daily, 'Daewoo Turmoil, Stringent NPL Standards Raise the Possibility' (September 13, 1999), available at '1999 WL 21564302'.
- Korea Times, 'Korea's Economic Spring May Be Just Around Corner' (April 27, 1999), available at '1999 WL 5592708'.
- Korean Industry Update, 'Financial Institutions' Bad Loans Shrink to US\$52.8 Billion' (September 2, 1999), available at '1999 WL 6811623'.
- Kornai, Janos, 'The Soft Budget Constraint', 39 *Kyklos* 1, 3 (1986).
- _____, 'The Hungarian Reform Process: Visions, Hopes and Reality', 24 *Journal of Economic Literature* No. 4 (1986).
- Kynge, James & Harding, James, 'China Suffers Biggest Financial Failure', *Fin. Times* (October 7, 1998).
- Kynge, James & Montagnon, Peter, 'China: Warning Over Ability to Halt Deflation', *Fin. Times* (September 7, 1999).
- Kynge, James & Suzman, Mark, 'China to Enter WTO after Signing US Deal', *Fin. Times* (November 16, 1999).
- Kynge, James, 'China's Public Show of Capitalism', *Fin. Times* (December 17, 2000).
- _____, 'Beijing Move on Foreign Currency', *Fin. Times* (September 5, 2000).
- _____, 'China to Liberalize Rates Regime within Three Years', *Fin. Times* (July 19, 2000).
- _____, 'China "Becoming More Capitalist"', *Fin. Times* (May 11, 2000).
- _____, 'Chinese Pension "in Crisis"', *Fin. Times* (April 9, 2000).
- _____, 'Riots in Chinese Mining Town', *Fin. Times* (April 3, 2000).
- _____, 'Beijing to Speed up Market Reforms', *Fin. Times* (March 30, 2000).
- _____, 'China to Boost Liquidity in Bourses', *Fin. Times* (March 21, 2000).
- _____, 'China Should Move to Convertibility', *Fin. Times* (March 14, 2000).
- _____, 'China Closes ITICs in Hainan', *Fin. Times* (March 1, 2000).
- _____, 'China to Speed up Financial Reforms', *Fin. Times* (January 21, 2000).
- _____, 'China: Beijing Plans Medical Scheme', *Fin. Times* (January 18, 2000).
- _____, 'China: A Fraught Fiscal Future', *Fin. Times* (January 11, 2000).
- _____, 'China: Central Bank Shift Trading Stance', *Fin. Times* (January 6, 2000).
- _____, 'China: Steel Plant Shut-down Planned', *Fin. Times* (January 1, 2000).

- ____, 'China: Report Reveals Banking Abuses', *Fin. Times* (December 17, 1999).
- ____, 'China: Total of Household Savings Falls', *Fin. Times* (December 16, 1999).
- ____, 'China's WTO Entry May Force Banks to Go Public', *Fin. Times* (December 13, 1999).
- ____, 'Think-Tank Warns of Banking Crisis in China', *Fin. Times* (November 17, 1999).
- ____, 'China: Beijing to Cut Steel Sector Output', *Fin. Times* (November 15, 1999).
- ____, 'China's Falling Prices Put Curb on Growth', *Fin. Times* (October 20, 1999).
- ____, 'China: Spending Boost for Social Securities', *Fin. Times* (September 4, 1999).
- ____, 'China: Beijing Relaxes Curbs on Foreign Banks', *Fin. Times* (August 27, 1999).
- ____, 'Beijing: China Bank Reform "Yet to Tackle All Faults"', *Fin. Times* (August 18, 1999).
- ____, 'China: Poor Revenues Hit Growth Hopes', *Fin. Times* (April 6, 1999).
- ____, 'China: Everbright Acquires State Bank', *Fin. Times* (March 19, 1999).
- ____, 'China: State Spending Boosts Output', *Fin. Times* (March 10, 1999).
- ____, 'China: Further State Statistics Blow', *Fin. Times* (February 27, 1999).
- ____, 'China: Budget Draft under Supervision', *Fin. Times* (February 26, 1999).
- ____, 'China: Products in "Oversupply"', *Fin. Times* (February 5, 1999).
- ____, 'China: Beijing Fillip for Private Sector', *Fin. Times* (February 4, 1999).
- ____, 'China: Talks Aim to Avert Business Failures', *Fin. Times* (January 20, 1999).
- ____, 'China: Beijing Lowers Growth Hopes', *Fin. Times* (January 7, 1999).
- ____, 'China: Industrial Parks to Lose Tax Perks', *Fin. Times* (January 7, 1999).
- Lam, Joseph & Kan, Carmen, 'Rules and Regulations on Insolvency and Restructuring in China', 11 *J.I.B.L.*, 351 (1999).
- Lam, Joseph, 'The Insolvency of GITIC', *J.I.B.L* No. 6, 193 (1999).
- Landlers, Mark, 'China Gives Foreign Creditors A Rude 1999 Awakening', *N. Y. Times*, 4 (January 12, 1999).
- Lange, Oscar, 'On the Economic Theory of Socialism', 4 *Review of Economic Studies* No. 1 53 (October 1936), No. 2 123 (February 1937).
- Lardy, Nicholas R., 'The Challenge of Bank Restructuring in China' in *Strengthening the Banking System in China: Issues and Experience*, BIS Policy Papers No.7, 17 (October 1999).
- Lastra, R. M. 'Crisis Management and Lender of Last Resort' in Lastra, R. M., Schiffman, Henry N. (eds.), *Bank Failures and Bank Insolvency Law in Economies in Transition*, 21 (1999).
- ____ 'Lender of Last Resort, An International Perspective', 48 *Int'l & Comp. L. Q.*, 342 (April 1999).

- Lau, Lawrence J., 'The Macroeconomy and Reform of the Banking Sector in China' in *Strengthening the Banking System in China: Issues and Experience*, BIS Policy Papers No. 7, 59 (October 1999).
- Leahy, Joe, 'Standard Chartered: Bali Withdrawal Worries Indonesia', *Fin. Times* (December 17, 1999).
- Lee, Brian Y., 'Taking Mortgage Interests In Real Property Under the Guarantee Law of the People's Republic of China', 21 *Hastings Int'l & Comp. L. Rev.* 539 (Winter 1998).
- Leggett, Karby, 'China's Bank-Debt Reforms Questioned', *Asian Wall St. J.*, 4 (May 3, 1999).
- _____, 'China Requires Stock Purchases to Be Voluntary', *Asian Wall Street Journal*, 17 (February 20-21, 1998).
- Leung, CY, 'First PRC Securities Law Fails to Clarify Regulation', *International Financial Law Review*, 45 (February 1999).
- Levitt, Michael S., 'The Abrogation of Forbearance Agreements: FIRREA's Ambiguities Demand a More Principled Analysis', 61 *Geo. Wash. L. Rev.* 1314, 1314-5 (June 1993).
- Li Shuguang, 'China: SOE Reform Plan Needs Rejigging', *China Daily*, 4 (May 5, 1999).
- Li, Shan & Zhu, Tian, 'An Open Financial Sectors Helps China', *The Asian Wall St. J.*, 14 (April 30, 1999).
- Lim, Alvin K., 'The S & L Crisis Revisited: Exporting an American Model to Resolve Thailand's Banking Problems', 9 *Duke J. Comp. & Int'l L.* 343, at 355-6 (Fall 1998).
- Lin, Ho Swee & Ostrovsky, Arkady, 'Beijing: Airport IPO Short of Full Take-up', *Fin. Times* (January 28, 2000).
- Lin, Ho Swee, 'GDE: Chinese Improve Offer to Finance Group's Creditor', *Fin. Times* (December 12, 1999).
- _____, 'GITIC: Payout Blow for Creditors', *Fin. Times* (October 23, 1999).
- Liu Zhongli, 'Report on the Implementation of the Central and Local Budgets for 1996 and on the Draft Central and Local Budgets for 1997', *Beijing Review* 30 (April 7-13).
- Liu, Hongru, 'Developments in the Reform of China's Banking and Financial System', 2 *J. Chinese L.* 323 (Fall, 1988).
- Liu, Shiyu, 'China's Experience in Small and Medium Financial Institution Resolution' in *Strengthening the Banking System in China: Issues and Experience*, BIS Policy Papers No. 7, 298 (October 1999).
- Liu, Weiling, 'Export-Import Business Tries to Feed Fund Hungary', *China Daily*, 1 (January 23, 1995).
- Lo, Chi, 'Despite Big Bad Loans, China Can Avert a Financial Crisis', *Asian Wall Street Journal*, 16 (Weekly Edition, January 5, 1998).
- Lopez, Leslie, 'Malaysia's Bad-Loan Agency is Moving Cautiously Toward Auctions', *Asian Wall St. J.* 4 (December 15, 1999).

- Luc, De Wulf, 'Financial Reform in China', *Financial & Development* 19 (December 1985).
- Lucas, Louise & Harding, James, 'China: Confidence Sinks With Full Gitic Debt', *Fin. Times* (January 11, 1999).
- Lucas, Louise & Jacob, Rahul, 'China: Province Funds Troubled Group', *Fin. Times* (March 2, 1999).
- Lucas, Louise, 'Hong Kong: Banks Face More Turmoil', *Fin. Times* (March 18, 1999).
- Lucas, R.E.Jr, 'On the Mechanics of Economic Development', 22 *Journal of Monetary Economics* 3 (1988).
- Lurey, Michael S., '11. Issues For Restructuring Public Debt Under Chapter 11' in *Business Loan Workout and Public Debt Restructuring 1988*, 601, Practicing Law Institute Commercial Law and Practice Course Handbook Series No. 465 (1988).
- M.J.B. Hall, *Banking Regulation and Supervision: A Comparative Study of the UK, USA and Japan*, 149 (1993).
- Macey, J. R. & Miller, G. P., 'Deposit Insurance, the Implicit Regulatory Contract, and the Mismatch in the Term Structure of Banks' Assets and Liabilities', 12 *Yale Journal on Regulation* 1 (1995).
- Maddison, A. 'Growth and Slowdown in Advanced Capitalist Economies: Techniques of Quantitative Assessment', 25 *Journal of Economic Literature*, 649 (1987).
- Man, Thomas Yunlong, 'National Legal Restructuring in Accordance with International Norms: GATT/WTO and China's foreign Trade Reform', 4 *Ind. J. Global Legal Stud.* 471 (Spring 1997).
- Martin Wolf, 'China's temptation: The Asian crisis has enhanced China's reputation but its ability to sustain a stabilising role must be questioned', *Fin. Times* (January 30, 1998).
- Mchulty, Shella, 'Malaysia: Bank Control Tightened', *Fin. Times* (April 1, 1999).
- McKillop D. G. & Ferguson C., *Bad Debt Provision and Write-offs: The Experience of UK Building Societies, 1989-1991*, IEF Research Papers in Banking and Finance 96/2 (1996).
- McNulty, Sheila, 'Malaysia: There Were 10 in the Bed', *Fin. Times* (January 21, 2000).
- _____, 'Malaysia: Economic Slide Comes to An End', *Fin. Times* (August 26, 1999).
- McNulty, Shella, 'Singapore to Liberalize Its Banks', *Fin. Times* (May 18, 1999).
- _____, 'Singapore: Bank Reforms "Not Big Bank"', *Fin. Times* (May 18, 1999).
- McTague, Jim, 'Queue Formsfor FSLIC's Biggest Payout', *American Banker* 422 (March 9, 1987).
- Michael Minor & Karen J. Stevens-Minor, 'China's Emerging Bankruptcy Law', 22 *Int'l. Law.* 1217, 1218 (1988).
- Miller, Geoffery P., 'Deposit Insurance for Economies in Transition' in Lastra, R. M., Schiffman, Henry N. (eds.), *Bank Failures and Bank Insolvency Law in Economies in Transition*, 37 (1999).

- Miller, Matthew & Wong, Lana, 'Official Back Gzitic Revamp, Seek Reprieve Debt Officials Back Gzitic Rejig, Seek Standstill on Debts', *South China Morning Post* 1 (March 18, 1999).
- Miller, Matthew, 'Questions of Felony Emerge in Gitic Crash', *South China Morning Post* 3 (April 23, 1999).
- _____, 'Assets, Debt Shock at Gitic Units', *South China Morning Post* 1 (April 22, 1999).
- _____, 'Hainan Itic's "Arrogant" Rejection of Repayment Requests Angers Koreans', *South China Morning Post* 3 (March 30, 1999).
- Miller, Sheryl, 'Institutional Impediments to the Enforcement of China's Bankruptcy Laws', 8 *Int'l Legal Persp.* 187 (Fall 1996).
- Mises, Ludwig Von, 'Economic Calculations in the Socialist Commonwealth', in Hayek, Friedrich A. (ed.), *Collective Economic Planning* (1935).
- Mitchell, Janet, 'Creditor Passivity and Bankruptcy: Implications for Economic Reform', in Mayer, Colin & Vives, Xavier (eds.), *Capital Markets and Financial Intermediation* (1993).
- Mo YK, 'A Review of Recent Banking Reforms in China' in *Strengthening the Banking System in China: Issues and Experience*, BIS Policy Papers No. 7, 90 (October 1999).
- Mogg, John F., 'Internal Controls: The EC Response to BCCI', in Kinsella, Ray (ed.), *Internal Controls in Banking* (1995).
- Monfort, Mark E., 'Reform of the State-Owned Enterprises and The Bankruptcy Law in the People's Republic of China', 22 *Okla. City U. L. Rev.* 1067 (Fall 1997).
- Montagnon, 'China: Foreign Competitors Vital, Says Top Banker', *Fin. Times* (October 27, 1999).
- Montagnon, Peter & Graham, George, 'Beijing: China to Give HSBC and Standard Chartered Renminbi Loans', *Fin. Times* (October 19, 1999).
- Montagnon, Peter & Harding, James, 'China: Bank Cut Non-performing Loans', *Fin. Times* (September 13, 1999).
- Montagnon, Peter & Jacob, Rahul, 'Asian Recovery: Banking on Borrowed Time', *Fin. Times* (November 18, 1999).
- Montagnon, Peter & Ridding, John, 'Banks "Face Years of Losses and Cuts"', *Fin. Times* (November 25, 1997).
- Montagnon, Peter, 'Korea: IFC Backs Debt Restructuring', *Fin. Times* (February 7, 2000).
- _____, 'China: Market Economy Is "Set Policy"', *Fin. Times* (January 21, 2000).
- _____, Thoenes, Sander, 'Indonesia: Tough Time for Bank Managers', *Fin. Times* (May 4, 1999).
- _____, 'China: Boost for Foreign Shareholders', *Fin. Times* (February 4, 1999).
- Mufson, Steven, 'China's Economic "Boss": Zhu Rongji to Take Over as Premier', *Washington Post*, A1 (March 5, 1998).
- Mure Dickie, 'China: New Tax to Spur Spending', *Fin. Times* (October 15, 1999).

- Nagle, Reid & Petersen, Bruce, 'Capitalization Problems in Perspective', in Aspinwall, Richard C. & Eisenbeis Robert A. (eds.), *Handbook for Banking Strategy* (1985).
- Nakamae, Naoko & Tett, Gillian, 'Japanese Banks Join Merger Rush', *Fin. Times* (October 15, 1999).
- _____, 'Auction Loans Aid Japan Bank Overhaul', *Fin. Times* (April 5, 1999).
- Nakamae, Naoko, 'Japan: Banks Collect 22.5% of Bad Loans', *Fin. Times* (April 13, 1999).
- _____, 'Kokumin Bank Declared Insolvent', *Fin. Times* (April 12, 1999).
- _____, 'IBJ: Plan to Halt Western Threat', *Fin. Times* (April 8, 1999).
- _____, 'Japan: Banking Rules Relaxed', *Fin. Times* (March 26, 1999).
- Nakamoto, Michiyo, 'Japan: Questions Raised in Osaka Bank Collapse', *Fin. Times* (August 9, 1999).
- Namgyal, Tsering, 'Taiwan: Let Banks Decide on Earthquake Mortgages', *Fin. Times* (October 6, 1999).
- Nation, 'SCB's recapitalization roadshow an Enormous Success' (April 30, 1999), available at '1999 WL 15653327'.
- _____, 'S-One Offers Solution for Bank NPLs' (April 12, 1999), available at '1999 WL 15652871'.
- Neoh, Anthony, 'Rethink Asia: Reality Check', *Far E. Econ. Rev.*, 46 (May 6, 1999).
- Norman, Peter, 'Ways to Boost Global Banking Stability Proposed by 12 Industrialized Nations', *Wall Street Journal* 3 (December 11, 1987).
- O'Neill, Mark, 'Creditors Combine in Bid to Revive Plant', *South China Morning Post*, 3 (October 30, 1999).
- _____, 'Debt Deal Boosts Ex-military Firm', *South China Morning Post*, 4 (October 27, 1999).
- _____, 'Foreign Bankers Remain Sceptical as Cinda Takes Equity in Five Companies Debt-swap Deals to Test Reform Plan', *South China Morning Post*, 2 (October 14, 1999).
- _____, 'Asset Manager Launch Hailed But Buyers May not Come Running', *South China Morning Post* 4 (April 21, 1999).
- _____, 'Bad-Debt Company Open for Business', *South China Morning Post* 4 (April 21, 1999).
- O'Sullivan, Diarmid, 'Indonesia to Speed Debt Restructuring', *Fin. Times* (November 26, 1999).
- Ongdee, Sasithorn, 'Thai Banks Need at Least Bt41 Billion', *Nation (Thailand)* (December 3, 1999).
- Park, Yung Chul, 'The Banking Reform in Korea: Issues and Challenges' in *Strengthening the Banking System in China: Issues and Experience*, BIS Policy Papers No. 7, 263 (October 1999).

- Peng Xiaohua, Characteristics of China's First Bankruptcy Law, 28 *Harv. Int'l. L.J.* 373, 373 n.1 (1987).
- Peterson, Manfred O., 'Regulatory Objectives and Conflicts', in Aspinwall, Richard C. & Eisenbeis Robert A. (eds.), *Handbook for Banking Strategy* (1985).
- _____, 'Conflicts between Monetary Policy and Bank Supervision', *Issues in Bank Regulation* 26 (Autumn 1977).
- Philips, Michael M., 'One by One: A Look at How the Global Finance Crisis Began', *Asian Wall St. J.*, S2 (May 3, 1999).
- Polizatto, V. P., 'Prudential Regulation and Banking Supervision' in Vittas, Dimitri (ed.), *Financial Regulation: Changing the Rules of the Game*, 310 (1992).
- Pornfret, John, 'China Set to Tackle Economic Woes; Government Plan Readied to Deal with Massive Bank Debt', *The Washington Post*, A21 (January 16, 1999).
- Posen, Adam S., 'Financial Fragility and the Risks of Crisis: the Case of Japan', 23-SPG Fletcher F. World Aff. 109, 119 (Winter-Spring 1999).
- Pyle, David H. 'Capital Regulation and Deposit Insurance', 10 *Journal of Banking and Finance* 189 (1986).
- Qian, Yingyi, 'Financial System Reform in China: Lessons from Japan's Main Bank System', in Aoki, Masahiko & Hume Patrick, *The Japanese Main Bank System: Its Relevance for Developing and Transforming Economies* (1994).
- Ramoncito dela Cruz, 'China Bank Deal Seen as Start of Consolidation', *Asian Wall St. J.* 4 (December 14, 1999).
- Reckard, E. Scott, Magnier, Mark, 'O.C. Investment Group to Buy \$1.7 Billion in Bad Japanese Loans Finance: William Popejoy and Partners Take on "Nonperforming Assets" for Fraction of Face Value', *Los Angeles Times* C1 (April 2, 1999).
- Restall, Hogo, 'China's Banking Time Bomb', *Asian Wall St. J.* 6 (September 2, 1999).
- Reynolds, Nicholas, Chan, Peter & Kohli, Sheel, 'HSBC Braces for Wave of Bad Debt', *South China Morning Post*, 1 (February 24, 1998).
- Rodgers P., 'The Bank of England Act', *Bank of England Q. Bull.* 97-99 (May 1998).
- _____, 'Changes at the Bank of England', *Bank of England Q. Bull.* 246 (August 1997).
- Rohwar, Jim, 'Outlook for Japan', *Fortune Magazine* 40 (March 29, 1999).
- Romer P., 'Increasing Returns and Long-run Growth', 94 *Journal of Political Economy* 1002 (1986).
- Romer, Thomas & Weingast, Barry R., 'Congress: The Genesis of the Thrift Crisis', 2 *Stan. L. & Pol'y Rev* 37 (Spring 1990).
- Rosen, Jeremy Brooks, 'China: Emerging Economies, and the World Trade Order', 46 *Duke L. J.* 1519 (April 1997).
- Rosen, Leonard M., *et al.*, '17. Approval and Confirmation of Chapter 11 Plans and Related Issues', in *Business Loan Workout and Public Debt Restructuring 1988*, 601,

- Rosenblum, Harvey & Pavel, Christine, 'Bank Services in Transition: The Effects of Nonbank Competitors', in Aspinwall, Richard C. & Eisenbeis Robert A. (eds.), *Handbook for Banking Strategy* (1985).
- Ross, Lester & Silk, Mitchell A., 'Banking on Change', 22 *China Business Review*, 35-39 (November-December 1995).
- Rowley, Anthony, 'Tokyo to Allow Foreign Take-over of 2 Japanese Banks', *Business Times (Singapore)* 1 (March 25, 1999).
- Sahling, Leonard, 'Managing the Cleanup of the Thrift Crisis', *Real Estate Rev.* (Winter 1993).
- Salsi, Giampaolo, 'The New Italian Law on Securitization', *J.I.B.L.*, 394 (1999).
- Sapsford, Jathon, 'Disclosure of "Gray Area" Loans Helped to Restore Investor Confidence', *The Wall Street Journal* B4 (March 31, 1999).
- _____, 'The Outlook: What Asia May Need Is Far Slower Growth', *Wall Street Journal*, A1 (November 3, 1997).
- Saunders, Anthony, 'Book Review: The Separation of Commercial and Investment Banking: The Glass-Steagall Act Revisited and Reconsidered. By George J. Benston. Oxford University Press, 1990.', 46 *The Journal of Finance* No. 2, 796 (June 1991).
- Savage, Donald T., 'Depository Financial Institutions', in Aspinwall, Richard C. & Eisenbeis Robert A. (eds.), *Handbook for Banking Strategy* (1985).
- _____, 'A History of the Bank Holding Company Movement, 1900-78', in *The Bank Holding Company Movement to 1978: A Compendium, a study by the staff of the Board of Governors of the Federal Reserve System* (1978).
- Sayson, Ian, 'Mergers: Philippine Banks Hear Wedding Bells', *Fin. Times* (October 28, 1999).
- _____, 'BPI/FAR EAST: Merger to Form Philippines' Biggest Bank', *Fin. Times* (October 21, 1999).
- Schaffer, Mark E., 'The Credible-Commitment Problem' in the Centre-Enterprise Relationship', 13 *Journal of Comparative Economics* No.3, 359 (September 1989).
- Schiffman, Henry N., 'Legal Measures to Manage Bank Insolvency in Economies in Transition' in Lastra, R. M., Schiffman, Henry N. (eds.), *Bank Failures and Bank Insolvency Law in Economies in Transition*, 81 (1999).
- Schill, Michael H., 'Uniformity of Diversity: Residential Real Estate Finance Law in the 1990s and the Implications of Changing Financial Markets,' 64 *S. Cal. L. Rev.* 1261 (1991).
- Schwartz, Anna J., 'Financial Stability and the Federal Safety Net', in Harif, William S. & Kushmeider, Rose Marie (eds.), *Restructuring Banking & Financial Services in America* (1988).

- Seebach, Steven L., 'Bankruptcy Behind the Great Wall: Should U.S. Businesses Seeking to Invest in the Emerging Chinese Market Be Awary?' 8 *Transnat'l Law*. 351 (Fall 1995).
- Sender, Henry, 'China: Floods of Money', *Far Eastern Economic Review* No. 54 (October 1, 1998).
- Shameen, Assif & Gearing Julian, 'An Industry Gets a Haircut: The Changes Have Only Begun for Thai Banking', *Asia Week* (April 23, 1999).
- Sharpe, William F., 'Bank Capital Adequacy, Deposit Insurance, and Security Values', *Journal of Financial and Quantitative Analysis* 701 (November 1978).
- Sheard, Paul, 'Main Banks and the Governance of Financial Distress' in Aoki, Masahiko & Patrick, Hui (eds.), *The Japanese Main Bank System*, 180-230 (1994).
- Shenker, Joseph C. & Colletta, Anthony J., 'Asset Securitization: Evolution, Current Issues and New Frontiers', 69 *Tex. L. Rev.* 1369 (1991).
- Shimada, Yoshiki & Itoh, Shinji, 'Japanese Asset Securitization: A Guide for Practitioners', 38, *Harv. Int'l L. J.*, 171 (1997).
- Shimamura, Kazuhiro, 'Japanese Banks Issue Shares to Ride out Dismal Fiscal Year', *Agence France-Presse* (March 31, 1999), available at '1999 WL 2574953'.
- Silverman, Gary, 'US: Bank Earnings Reliant on Stock Market', *Fin. Times* (January 19, 2000).
- Sinkey, Joseph F. Jr., 'Regulatory Attitudes toward Risk', in Aspinwall, Richard C. & Eisenbeis Robert A.(eds.), *Handbook for Banking Strategy* (1985).
- Sirithaveeporn, Wichit, 'Debt Restructuring: Bad Loans to Fall to 40% by End of Year', *Bangkok Post* 1 (December 15, 1999).
- Smith, Craig S., 'China's WTO Deal: Chinese Fear Short-run Effects of Pact- Great Foreign Competition Likely to Hurt Many State-owned Firms', *Asian Wall St. J.*, 10 (November 17, 1999).
- Smith, Michael, 'The London Approach and Trading in Distressed Debt', *Bank of England Quarterly Bulletin*, 222 (May 1996).
- Solomon, Jay & Linebaugh, Kate, 'Standard Chartered to Control Bank Bali-Jakarta Calls Move a Breakthrough in Its Effort to Revive Finance Sector', *Asian Wall St. J.* 1 (April 23, 1999).
- Solomon, Jay, 'Heard on the Street in Jakarta: Bank of Sinar Mas Group Shows Few Recovery Signs', *Asian Wall St. J.* 13 (March 25, 1999).
- Solow, Robert M., 'Technological Change and the Aggregate Production Function' 39 *Review of Economic Studies* 312 (1957).
- _____, 'A Contribution to the Theory of Economic Growth', 70 *Quarterly Journal of Economics* 65 (1956).
- South China Morning Post, 'Cement Plant Finds Life after Debt' (October 25, 1999).
- _____, 'Why the Process of Financial and State Enterprise Reform Should Continue?' *South China Morning Post*, 4 (May 13, 1999).

- _____, 'Bankers Wake up to Mainland Difficulties', *South China Morning Post* (January 29, 1999).
- Stigler, George J. 'The Theory of Economic Regulation', 2 *Bell Journal of Economics and Management* 3 (Spring 1971).
- Stiglitz, Joseph & Weiss, Andrew, 'Credit Rationing in Markets with Imperfect Information', 73 *American Economic Review* No. 3, 393 (June 1981).
- Stiglitz, Joseph E., 'Financial Market and Development', 5 *Oxford Review of Economic Policy* 61 (Winter 1989).
- Summaries Staff, 'Japanese Banks Post Healthy Profits', *Fin. Times* (November 19, 1999).
- _____, 'China and US Sign Historic WTO Deal', *Fin. Times* (November 15, 1999).
- _____, 'Mitsubishi Motors Cuts 12,000 Jobs', *Fin. Times* (October 26, 1999).
- _____, 'Nissan to Cut 21,000 Jobs', *Fin. Times* (October 18, 1999).
- _____, 'Japanese Banks: Asahi and Tokai Banks Link Up Plan Would Create Japan's Third Largest Banking Group', *Fin. Times* (October 7, 1999).
- _____, 'HSBC's Talks with SeoulBank Collapsed', *Fin. Times* (August 31, 1999).
- _____, 'S Korea: Power of Chaebol Curbed', *Fin. Times* (August 25, 1999).
- _____, 'Singapore to Liberalize Banking Sector', *Fin. Times* (May 17, 1999).
- _____, 'Hyundai to Split into Five and Cut Debt', *Fin. Times* (April 23, 1999).
- _____, 'Korea: Restructuring', *Fin. Times* (April 20, 1999).
- _____, 'Japanese Banks Announce Alliance', *Fin. Times* (January 20, 1999).
- _____, 'South Korea Chaebol Agree Shake-up', *Fin. Times* (December 7, 1998).
- Sun, Shangwu, 'Financial Reform Outlined', *China Daily*, 1 (February 23, 1998).
- Taggart, Robert A., Jr., 'Recent Developments in Business Financing', in Aspinwall, Richard C. & Eisenbeis Robert A. (eds.), *Handbook for Banking Strategy* (1985).
- Tang, Edward, 'Thailand Goes for Broke with New Bankruptcy Law', *The Straits Times (Singapore)* (March 30, 1999), available at '1999 WL 8249441'.
- Temkin, Gabriel, 'On Economic Reform in Socialist Countries: The Debate on Economic Calculation under Socialism Revisited', 1 *Communist Economies* No. 1 31 (1989).
- Tett, Gillian & Harney, Alexandra, 'Japanese Banking: Japanese Banking: Forging a Mega-Marriage', *Fin. Times* (August 23, 1999).
- _____, 'Banking: The Semantics of Consolidation', *Fin. Times* (August 21, 1999).
- _____, Alexandra, 'Japan, Banks Reveal Tie-up Plans', and 'Banking: The Semantics of Consolidation', *Fin. Times* (August 21, 1999);
- Tett, Gillian & Nakamae, Naoko, 'Asahi and Tokai Join Rush to Merge', *Fin. Times* (October 8, 1999).
- _____, 'Tokai Bank: ¥220bn Debts Forgive', *Fin. Times* (March 31, 1999).
- _____, 'LTCB: Shareholders to Lose All Investments', *Fin. Times* (March 31, 1999).

- ____, 'Japan: Banks Unveil Sell-off Moves', *Fin. Times* (March 16, 1999).
- ____, Naoko, 'Japan Banks Hide Losses with Secret Bond Deals', *Fin. Times* (January 27, 1999).
- ____, 'Japan to Abolish Withholding Tax Bonds', *Fin. Times* (December 21, 1998).
- Tett, Gillian, Nakamae, Naoko, Rahman, Bayan & Clifford, Lisa, 'Three Japanese Banks to Merge', *Fin. Times* (March 14, 2000).
- ____, 'Japan: Banks Write off Billions in Bad Loans', *Fin. Times* (February 2, 2000).
- ____, 'Improving Fortunes for Japan's Bank', *Fin. Times* (November 23, 1999).
- ____, 'Japanese Banks: Profits Prompt Hope of Recovery', *Fin. Times* (November 22, 1999).
- ____, 'Sumitomo/Daiwa: Japanese Banks Combine', *Fin. Times* (November 10, 1999).
- ____, 'Japan: The Circle Is Broken', *Fin. Times* (November 9, 1999).
- ____, 'Buyer Is Sought for Nippon Credit', *Fin. Times* (October 4, 1999).
- ____, 'Japan Banks Dip Into Treasure Troves', *Fin. Times* (April 22, 1999).
- ____, 'Banking: Japanese "Window Dressing" May Cost Dear', *Fin. Times* (April 6, 1999).
- ____, 'Japan: Banks Sold \$25bn of Bad Loans', *Fin. Times* (April 6, 1999).
- ____, 'Tokyo's Holdings in Banks Pose Questions', *Fin. Times* (February 24, 1999).
- ____, 'Japanese Banks Underestimated Bad Loans', *Fin. Times* (November 26, 1998).
- The Asian Wall Street Journal, 'Kamco Auctions off Unperforming Loans', *Asian Wall St. J.*, 4 (December 10, 1999).
- ____, 'Economic Recovery Helps Thailand Cut its Problem Loans' (December 9, 1999).
- ____, 'Transportation: One-Time Restructuring Gain Help Eurotunnel Post '98 Profit' (March 16, 1999), available at '1999 WL-WSJA 5429811'.
- The Economist, 'Freedom from Fear? Capitalism Will Always Have Dramas. It Is Governments That Turn Them into Crises', 352 *The Economist* (September 11, 1999).
- ____, 'Thailand's Banks: Non-Performing Lenders', *The Economist*, 71 (September 4, 1999).
- ____, 'Thailand: Stimulation' 350 *The Economist* 72 (March 27, 1999).
- ____, 'Survey: Prevention is Much Better than Cure', 350 *The Economist* 8104 (January 30, 1999).
- The Edge (Malaysia), 'Focus: Two Approaches to Restructuring' (May 3, 1999), available at '1999 WL 8861206'.
- ____, 'My Say: Managing the Economy in the Crisis' (May 3, 1999), available at '1999 WL 8861214'.
- The Lawyer, 'City: Firms Secure Tunnel Debt Deal' (February 24, 1998), available at '1998 WL 9166885'.

- The New Straits Times, 'Malaysia's Selective Currency Controls and Why They Worked' (September 3, 1999), *Speech by Prime Minister Dr. Mahathir at the 'Symposium of the First Anniversary of Currency Control' in Kuala Lumpur*.
- _____, 'Problem Loans: RM40b to Be Cleared by June' (April 21, 1999), *available at '1999 WL 7462320'*.
- The South China Morning Post, 'Big Borrowers in Ratings Test Move Seek More Prudential Lending' (21 July, 1999).
- _____, 'PBOC Blacklist Leaves Delinquent Borrowers Digging into Pockets' (July 19, 1999).
- Thoenes, Sander, 'Jakarta: Debt Repayment Push', *Fin. Times* (March 17, 1999).
- _____, 'Indonesia Bank Move "A Breakthrough"', *Fin. Times* (March 15, 1999).
- _____, 'Indonesia: Banks to Be Nationalised', *Fin. Times* (February 26, 1999).
- Tong Ting, 'Overseas RMB Banks Face 33% Taxes', *China Daily Business Weekly* 1 (June 2, 1997).
- _____, 'Eximbank's Functions Strengthened', *China Daily Business Weekly*, 3 (June 1, 1995).
- Tony, Boyd, 'Indonesia Gets \$76bn Bank Assets Sale on the Road', *Austl. Fin. Rev.* 32 (May 12, 1999).
- Toronto, Steven L., 'Bankruptcy of Foreign Enterprises in the PRC: An Interpretation of the "Rules Concerning Bankruptcy of Foreign Related Companies in the Shenzhen Special Economic Zone"', 4 *J. Chinese L.* 277 (1990).
- Ueda, Kazuo, 'The Japanese Banking Crisis in the 1990s' in *Strengthening the Banking System in China: Issues and Experience*, BIS Policy Papers No. 7, 251 (October 1999).
- Walker, Tong, 'China Reduces Bank Taxes', *Fin. Times* (March 3, 1997).
- Wang Chuangdong, 'Chinese Told: Live Now, Pay Later', *Business Weekly-China Daily* (May 16-22).
- Wang Lihong, 'Bad Loans Only 5% of Bank Credits', *China Daily*, 3 (January 17, 1998).
- _____, 'Trial Project Targets Debt', *China Daily Business Weekly*, 1 (October 7, 1996).
- Wang Xiaowei, 'Huge Credit Risks Seen in CIB Acquisition Everbright Takes over Bad Loans', *South China Morning Post* (March 19, 1999).
- Wang, Guiguo, 'China's Participation in International Organizations', in Rui Mu & Wang Guiguo (eds.), *China Foreign Economic Law: Analysis And Commentary* (1990).
- Wang, Xiangwei, 'Debt-clearing Scheme May Face Hurdles Official Says Swaps Not "A Free Lunch"', *South China Morning Post* 3 (December 11, 1999).
- _____, 'Everbright to Double Assets CIB Branches Changing Hands', *South China Morning Post* 4 (March 18, 1999).
- White, Eugene A., 'Before the Glass-Steagall Act: An Analysis of the Investment Banking Activities of National Banks', 23 *Explorations in Economic History* 33 (1986).

- Wilke, John R., 'FDIC Premiums for Most Banks Eliminated to Zero', *Wall Street Journal*, A4 (November 15, 1995).
- William Barnes, 'Siam Bank Gets \$13bn in Largest Share Sale', *South China Morning Post*, 4 (April 30, 1999).
- Wolf, Martin, 'China's temptation: The Asian Crisis Has Enhanced China's Reputation but Its Ability to Sustain a Stabilising Role Must Be Questioned', *Fin. Times* (January 30, 1998).
- Wolffe, Richard, 'US Congress to Limit Hedge Funds Risks', *Fin. Times* (March 2, 1999).
- Wonacott, Peter, 'China Terms for Bad Loans', *Wall Street Journal*, interactive edition (February 25, 1998).
- Wong Lana, 'New Units Confront Three-year Challenges over Bank Bad Loans', *South China Morning Post*, 5 (October 21, 1999).
- Wong, Christine P. W., 'The Economics of Shortage and Problems of Reform in Chinese Industry', 10 *Journal of Comparative Economics* No. 4, 363 (December 1986).
- Wong, Lana, 'Beijing Details Clean-up of Troubled Itics Sector', *South China Morning Post*, 1 (April 17, 1999).
- Wood, Geoffrey E., 'Crisis Management and Lender of Last Resort and Deposit Insurance in Economies in Transition: Comment — Routes to Systemic Stability' in Lastra, R. M., Schiffman, Henry N. (eds.), *Bank Failures and Bank Insolvency Law in Economies in Transition*, 71 (1999).
- Wu Jinglian, 'The Macroeconomic Trend in 1999 and Policy Options' in *Strengthening the Banking System in China: Issues and Experience*, BIS Policy Papers No. 7, 116 (October 1999).
- Xie, Ping, 'Bank Restructuring in China' in *Bank Restructuring in Practices*, 124, BIS Policy Papers No.6 (August 1999).
- _____, 'Toward a Market-Oriented Interst Rate Policy in the Transformation of China's Economy', in Mehran, Hassanali, Laurens, Bernard & Quintyn Marc (eds.), *Interest Rate Liberalization and Money Market Development*, 19 (1996).
- Xu Binglan, 'Central Bank's Decision to Boost Economy: PBOC Announces Interest Rate Cut', *China Daily* (June 10, 1999).
- Xu Dashan 'Banks Poised for Residential Mortgage Loans,' *China Daily* (June 15, 1998).
- Yatsko, Pamela, 'Strings Attached: Foreigners Get Limited Entry into Renminbi Banking', *Far Eastern Economic Review*, 52 (January 16, 1997).
- Yergin, Daniel, 'Daniel Yergin: Global Uncertainty', *Fin. Times* (March 8, 1999).
- Yip, Philip, 'Securitization— Is China Ready?' *International Business Lawyer*, 398 (October 1999).
- Yuthamanop, Parista, 'Debt Restructuring: Problem Loans Dip by 3.3% in October', *Bangkok Post*, 1 (December 9, 1999).

- Zhang Dingmin, 'China Cuts Interest Rate to Stimulate Consumption', *China Daily* (June 11, 1999).
- Zhong Qirui, 'Basic Outline for the National Interbank Market in Renminbi', in Mehran, Hassanali, Laurens, Bernard & Quintyn Marc (eds.), *Interest Rate Liberalization and Money Market Development* (1996).
- Zhou, Xiaochuan & Zhu, Li, 'China's Banking System: Current Status, Perspective on Reform', *Journal of Comparative Economics* No. 11, 399 (1987).
- Zhu Jun, 'Closure of Financial Institutions in China' in *Strengthening the Banking System in China: Issues and Experience*, BIS Policy Papers No. 7, 304 (October 1999).
- Zisman, Barry S. & Churchill, William O., 'Federal Assistance Relating to Failing and Failed Thrifts', 8 *Banking Expansion Rep.* 1, 12 (1989).

IV. CONFERENCES, UNPUBLISHED AND ELECTRONIC MATERIALS

- Abraham, J. P. & Lierman, F., 'European Banking Strategies in the Nineties: a Supply Side Approach', *Institute of European Finance Research Papers in Banking and Finance*, RP 91/8, Bangor (1991).
- AFX News, 'CSRC Issues Rules on Disclosure by Listed Financial Companies' (November 14, 2000), *available at '2000 WL 29253899'*.
- _____, 'China Financial Institutions Must Receive PBOC Approval for Bankruptcy', *available at '1999 WL 14935612'*.
- _____, 'Danaharta to Manage NPLs Based on Loan/Asset Management Strategies', *available at '1999 WL 14937128'*.
- _____, 'China Debt Disposal Via AMCs Seen "Worse than Imaginable' (December 8, 1999), *available at '1999 WL 25421659'*.
- _____, 'China to Cut Proportion of Loss-making State Firms to Under 30% by End-2000' (December 7, 1999), *available at '1999 WL 25421431'*.
- _____, 'China Urgent to Tackle Risks from Negative Growth in Bank Deposits' (December 6, 1999), *available at '1999 WL 25420973'*.
- _____, 'Sanwa Bank, 4 Other Financial Cos to Set up Loan Collection Venture' (December 2, 1999), *available at '1999 WL 25420820'*.
- _____, 'China Debt/Equity Swaps Risk Create Economy of Debt-Repudiation' (October 12, 1999), *available at '1999 WL 25408865'*.
- _____, 'PBOC Allows Several Securities Firms, Funds into Interbank Market-Dealers' (September 24, 1999).
- _____, 'PBOC Plans Equity Issues to Finance Bad Loan Purchases from State Banks' (April 5, 1999), *available at '1999 WL 14936791'*.
- _____, 'LTCB Bad Loans Reportedly Investigated by Japan Police' (April 5, 1999).

- _____, 'Thai MoF to Allow NPLs to Become Performing After Debt Plans Signed' (March 30, 1999), *available at '1999 WL 14935808'*.
- Agency France-Presse, 'China Central Bank to Boost Financial Monitoring', *available at '1999 WL 2579951'*.
- _____, 'Chinese State Firms Ink 631 Million Dlr in Debt-Equity Swaps', *available at '1999 WL 25141350'*.
- _____, 'China in All-out Push to Expand Non-State Banks: Report' (November 11, 1999), *available at '1999 WL 25141457'*.
- _____, 'First Foreign Bank in China in Yuan Rediscount Transaction' (November 8, 1999), *available at '1999 WL 25139859'*.
- _____, 'Daewoo's Korean Creditors to Swap Half of 50 bln Dlr Loans for Equities' (November 2, 1999), *available at '1999 WL 25136124'*.
- _____, 'Daewoo Creditors to Swap 25bn Dlr in Loans for Shares as Execs Resign' (November 2, 1999), *available at '1999 WL 25136160'*.
- _____, 'China Steps up Number of Asset Management Companies to Manage Bad Debts' (October 16, 1999), *available at '1999 WL 25125484'*.
- _____, 'China's Banking Reforms Slowly Yields Results: IFC Official' (May 13, 1999), *available at '1999 WL 2601586'*.
- _____, 'China Opens First Asset Management Company for Bad Loans', (April 20, 1999), *available at '1999 WL 2586720'*.
- _____, 'Pakistani Bank to Sell Mortgaged Units to Recover Bad Loans' (April 5, 1999), *available at '1999 WL 2577353'*.
- _____, 'Indonesia to Set up Financial Supervisory Body by 2002' (April 5, 1999), *available at '1999 WL 2577434'*.
- _____, 'China's Finances "Manageable" Despite ITIC Problems: Central Bank' (April 5, 1999), *available at '1999 WL 2577290'*.
- _____, 'Shenzhen Banks Set to Begin China's First Debt Securitization: Official' (March 30, 1999), *available at '1999 WL 2573636'*.
- _____, 'Eurotunnel Pulls into Profits with Restructuring' (March 15, 1999), *available at '1999 WL 2564261'*.
- Asahi Shimbun/Asahi Evening News, 'Business: Interview: Hirofumi Gomi, Dir-Gen, Financial Supervisory Agency: Building Trust in Japan's Financial Institutions' (May 10, 1999), *available at '1999 WL 17698732'*.
- Asia Pulse, 'Indonesia to Save Auto Maker through Debt/Equity Swap' (November 10, 1999), *available at '1999 WL 27967423'*.
- _____, 'Japan FRC Oks Purchase of Bad Loans from Healthy Banks' (September 14, 1999), *available at '1999 WL 18773880'*.
- _____, 'China to Convert State Firms' Debt into Equity' (September 3, 1999), *available at '1999 WL 18772379'*.

- _____, 'Chinese Firms Sign Country's First Debt-to Equity Deal' (September 3, 1999), *available at '1999 WL 18772310'*.
- _____, 'Indonesian Govt Sets up Consortium to Settle NPLs' (May 11, 1999), *available at '1999 WL 5098789'*.
- _____, 'Profile- China Banking Services (April 1999)', *available at '1999 WL 5095417'*.
- _____, 'BOJ to Shift Focus of Bank Inspections to Risk Management' (March 31, 1999), *available at '1999 WL 5092120'*.
- _____, 'Profile - China's Textile Industry' (March 1999), *available at '1999 WL 5092146'*.
- _____, 'Japan's RTC to Buy Loans from Ailing Financial Institutions' (March 25, 1999), *available at '1999 WL 5091272'*.
- AsiaWeek, 'Viewpoint: A Less Political RMB: The WTO Will Lead to a More Flexible Exchange Rate' (November 26, 1999), *available at '1999 WL 29325836'*.
- _____, 'Business: Chaebol: Deconstructing Daewoo: One Crisis May be Averted, But the Debts Remain' (November 12, 1999), *available at '1999 WL 29325670'*.
- Banoo, Sreerema, 'Holding Companies Barred from Non-Banking Activities', *Business Times* (Malaysia) 1 (April 1, 1999), *available at '1999 WL 13391570'*.
- Bernama, 'Danaharta to Finish Restructuring by June, Unveils Guidelines' (April 7, 1999), *available at '1999 WL 5598028'*.
- _____, 'Japan: FSA Eases Bad-Loan Classification, Loss-Reserve Rules', *available at '1999 WL 5598000'*.
- Business Asia, 'South Korea: Faltering Financials' (April 5, 1999), *available at '1999 WL 10768537'*.
- Business China, 'Cash-strapped' (September 27, 1999), *available at '1999 WL 2498061'*.
- Business Day (Thailand), 'Banks, Finance Firms Increased Capital by Baht 817bn: BOT' (December 3, 1999), *available at '1999 WL 19609749'*.
- _____, 'One Trillion Baht More Needed to Bail out Finance Industry: BOT' (December 2, 1999), *available in '1999 WL 19609726'*.
- Business Recorder, 'Provisioning for Bad Debts: State Bank Allows Banks to Deduct Collateral Value' (April 21, 1999), *available at '1999 WL 14886633'*.
- Business Week, 'China's Bad-debt Cops Get Going' (October 11, 1999), *available at '1999 WL 27295452'*.
- _____, 'Why Japan is Stuck', *available at '1999 WL 8226852'*.
- Business World (Philippines), 'Bad Debts of Firms Tax Deductible' (March 18, 1999), *available at '1999 WL 5615997'*.
- Cecil Morella, 'Asia Makes Slow Progress on Bankruptcies', *Agence France-Presse* (May 16, 1999), *available at '1999 WL 2603180'*.
- Chanjindamanee, Siriporn, 'Bt 100 bn in Assets to Be Restructured', *WorldSouces Online* (March 29, 1999), *available at '1999 WL 3465294'*.

- China Business Information Network, 'China: SOEs Sign Huge Debt-Equity Swap Agreements' (November 11, 1999), *available at* '1999 WL 17731936'.
- _____, 'China: Debt-to-equity Swaps: A "Win-Win" Choice for Banks and Firms' (October 20, 1999), *available at* '1999 WL 17731561'.
- _____, 'China: ADB: Chinese Banks Need 5-Year Reprieve before Liberalization' (April 22, 1999), *available at* '1999 WL 5618989'.
- _____, 'China: Court Hearing Begins on Bankruptcy of Gitic in Shenzhen' (April 22, 1999), *available at* '1999 WL 5618970'.
- _____, 'China's Central Bank to Open Its First Debt-Clearing House' (March 29, 1999), *available at* '1999 WL 5618636'.
- _____, 'China: Geographical Limits on Foreign Financial Institutions to Go', *China Business Information Network* (January 28, 1999).
- China News Agency, 'Central Bank Cites Impact of Bankruptcies' (December 18, 1995), *translated in* *FBIS-CHI-95-243*, 62 (December 19, 1995).
- Chinaonline, 'Huarong Asset Management Turns to Net to Unload Nonperforming Assets' (April 2, 2001), *available at* 'http://www.chinaonline.com/topstories/010403/b101032933.asp'.
- _____, 'Guangdong Guangye AMC Opens 6 Ailing Firms to Public Bidding' (March 29, 2001), *available at* 'http://www.chinaonline.com/topstories/010329/1/C01032204.asp'.
- _____, 'State-Owned Commercial Banks to Offer Long-term Financial Bonds' (March 14, 2001), *available at* 'http://www.chinaonline.com/topstories/010314/1/C01031302.asp'.
- _____, 'Huangrong Asset Management Looks Overseas for bad-debt buyers' (March 5, 2001), *available at* 'http://www.chinaonline.com/issues/econ_news/NewsArchive/secure/2001/March/B20102211.asp'.
- _____, 'Asset Management Firms Struggling to Recoup Debts' (April 19, 2001), *available at* 'http://www.chinaonline.com/topstories/010419/1/c01041105.asp'.
- _____, 'Huarong Asset Management Partners with Ernst & Young' (February 26, 2001), *available at* 'http://www.chinaonline.com/topstories/010226/1/C01022102.asp'.
- _____, 'Chinese, South Korean Firms Sign Nonperforming Asset Management Agreement' (February 12, 2001), *available at* 'http://www.chinaonline.com/topstories/010212/1/C01020508.asp';
- _____, 'Banks Cash in on Best Business in Six Years' (January 19, 2001), *available at* 'http://www.chinaonline.com/topstories/010119/1/B201011501.asp'.
- _____, 'PBOC: Financial Adjustment and Control Targets Achieved in '00' (January 19, 2001), *available at* 'http://www.chinaonline.com/topstories/010119/1/B201011605.asp'.

- ____, 'Foreign Investment in China Surpasses US\$40B Last Year' (January 18, 2001), available at '<http://www.chinaonline.com/topstories/010118/1/C01011707.asp>'.
- ____, 'Financial Institutions Woo Overseas Professional' (January 11, 2001), available at '<http://www.chinaonline.com/topstories/010111/1/B101010901.asp>'.
- ____, 'Foreign Investors a Useful Tool in Disposing Nonperforming Assets in China, Exec Says' (January 3, 2001), available at '<http://www.chinaonline.com/topstories/010103/1/B100122510.asp>'.
- ____, 'Three-year Goals for SOE Reform and Relief Mostly Realized' (January 2, 2001), available at '<http://www.chinaonline.com/topstories/010102/C00122803.asp>'.
- ____, 'Huarong Asset Management Files Bad Debt Lawsuits' (January 2, 2001), available at '<http://www.chinaonline.com/topstories/010101/1/C00122706.asp>'.
- ____, 'A Little off the Top: Big 4 Banks Drop 10% of Bad Debt' (December 19, 2000), available at '<http://www.chinaonline.com/industry/financial/newsarchive/secure/2000/December/c00121506.asp>'.
- ____, 'China's Securities Market Valued at US\$556.44B' (December 15, 2000), available at '<http://www.chinaonline.com/topstories/001215/1/B200121318.asp>'.
- ____, 'China Huarong Asset Management Turns Liabilities into Assets with Sale' (December 12, 2000), available at '<http://www.chinaonline.com/topstories/001212/1/C00121112.asp>'.
- ____, 'GITIC Distributes US\$84.5 Million to Creditors' (November 7, 2000), available at '<http://www.chinaonline.com/topstories/001107/C00103110.asp>'.
- ____, 'Consultant Warns Foreign Investors Seeking to Buy Bad Assets in China' (September 15, 2000), available at '<http://www.chinaonline.com/topstories/000915/1/B200091313.asp>'.
- ____, 'Damage Control Xinda AMC Launches 38 Debt-for-Equity Projects' (September 14, 2000), available at 'http://www.chinaonline.com/issus/econ_news/currentnews/secure/B200091307.asp'.
- ____, 'Pension Fund Shows Deficit in 1H' (September 12, 2000), available at '<http://www.chinaonline.com/topstories/000912/1/C00090713.asp>'.
- ____, 'PBOC Allows Financial Companies to Join Money Markets' (September 7, 2000), available at '<http://www.chinaonline.com/topstories/000907/1/B100090623.asp>'.
- ____, 'Shangdong's Bank Sector Establishes Business Credit Information System' (August 4, 2000), available at '<http://www.chinaonline.com/industry/financial/currentnews/secure/C00072814.asp>'.
- ____, 'Asset Management Cos. Receive US\$157bn of Bad Assets from Banks' (August 3, 2000), available at 'http://www.chinaonline.com/issues/econ_news/currentnews/secure/B200072705.asp'.

- ____, 'China Permits Leasing Companies to Invest in Securities' (July 27, 2000), *available at* '<http://www.chinaonline.com/topstories/000727/1/C00072508.asp>'.
- ____, 'Conversion Diversion: No Timetable Set to Float Renminbi, China Central Banker Exhorts' (July 19, 2000), *available at* '<http://www.chinaonline.com/topstories/000719/1/c00071951.asp>'.
- ____, 'Insurance Company, Bank Team on Credit Card' (July 17, 2000), *available at* '<http://www.chinaonline.com/topstories/000717/B100071219.asp>'.
- ____, 'Banking, Securities, Insurance Industries Increase Cooperation' (July 13, 2000), *available at* '<http://www.chinaonline.com/topstories/000713/1/b200071001.asp>'.
- ____, 'Mercy Killing: Beijing to Give Ailing SOEs the Gift of Bankruptcy' (July 12, 2000), *available at* '<http://www.chinaonline.com/topstories/000712/1/B100071144.asp>'.
- ____, 'Bank of Communications Prepare to Go Public' (July 7, 2000), *available at* '<http://www.chinaonline.com/topstories/000707/1/C00070505.asp>'.
- ____, 'Trial Opens for 3 Accused of Spreading Rumors about the Bank of Communications' (June 30, 2000), *available at* '<http://www.chinaonline.com/topstories/000630/1/C00062910.asp>'.
- ____, 'China SOE Asset-Management Firm Hits up Private Sector for Capital' (June 21, 2000), *available at* 'http://www.chinaonline.com/issues/econ_news/currentnews/secure/B100061635.asp'.
- ____, 'Bankers' Hours Just Got Shorter: Central Bank Shuts Down Three Wuhan Financial Institutions' (July 11, 2000), *available at* '<http://www.chinaonline.com/topstories/000711/1/c00071008.asp>'.
- ____, 'Auditor: ICBC, CBC's Illegal Operations Cost China US\$1.2b' (July 11, 2000), *available at* '<http://www.chinaonline.com/topstories/000711/1/C00070612.asp>'.
- ____, 'Asset-management Firms Continue Restructuring Money-losing State-owned Enterprises' (June 28, 2000), *available at* '<http://www.chinaonline.com/topstories/000628/1/b200062612%20.asp>'.
- ____, 'BOC to Use Reuters' Risk Management System' (June 9, 2000), *available at* '<http://www.chinaonline.com/industry/financial/currentnews/secure/C00060701.asp>'.
- ____, 'China Huarong Auction Off First Bad Asset' (June 1, 2000), *available at* '<http://www.chinaonline.com/industry/fina...wsArchive/Secure/2000/june/C00053106.asp>'.
- ____, 'Beijing Bank's Efforts to Fund Hi Tech Park Stalled by Gov't' (May 10, 2000), *available at* '<http://www.chinaonline.com/topstories/00050101/1/C00050405.asp>'.
- ____, 'CITIC to Form Financial Firm by Year's End' (March 9, 2000), *available at* '<http://www.chinaonline.com/topstories/000309/2/C00030711.asp>'.
- ____, 'China Construction Bank to Issue Bonds for Mortgage Loans' (April 25, 2000), *available at* '<http://www.chinaonline.com/industry/financial/currentnews/secure/B20004204.asp>'.

- ____, 'China Asset-Management Firms Offer Shares to Foreign Firms' (April 20, 2000), available at '<http://www.chinaonline.com/topstories/000420/2/C00041910.asp>'.
- ____, 'China Social Security in Crises' (April 13, 2000), available at '<http://www.chinaonline.com/topstories/000413/c00041205.asp>'.
- ____, 'Cross-Sector Finance Still Banned in China' (April 6, 2000), available at '<http://www.chinaonline.com/topstories/000406/2/b200040304.asp>'.
- ____, 'China Should Open up Capital Account- Expert' (April 6, 2000), available at '<http://www.chinaonline.com/topstories/000406/2/B100033124.asp>'.
- ____, 'China Gains First Consumer Credit Bureau' (April 6, 2000), available at '<http://www.chinaonline.com/topstories/000406/2/C00040508.asp>'.
- ____, 'Run on Chinese Banks Unlikely-Survey' (April 4, 2000), available at '<http://www.chinaonline.com/topstories/000404/2/C00032404.asp>'.
- ____, 'Real-Name Ids Required for Personal Bank Accounts in China' (April 3, 2000), available at '<http://www.chinaonline.com/topstories/000403/2/C00033111.asp>'.
- ____, 'China's Largest Aluminum Co. to Undergo Debt-to-Equity Swap' (April 3, 2000), available at '<http://www.chinaonline.com/topstories/000403/2/C00033007.asp>'.
- ____, 'China White Paper Seeks to Strengthen Stock, Securities Markets' (March 29, 2000), available at '<http://www.chinaonline.com/topstories/000329/1/C00032805.asp>'.
- ____, 'New Rules Released for China's State-Owned Financial Firms' (March 23, 2000), available at '<http://www.chinaonline.com/topstories/000323/2/B200032201.asp>'.
- ____, 'Does China Need a Trillion Dollar Stock Market?' (March 23, 2000), available at 'http://www.chinaonline.com/commentary_an...economics/currentnews/open/C00032320.asp'.
- ____, 'China Simplifies, Strengthens Listing Regs' (March 21, 2000), available at '<http://www.chinaonline.com/topstories/000321/2/B200031701.asp>'.
- ____, 'Two China Insurance Cos. Get Better Stock Market Listing Ratios' (March 16, 2000), available at '<http://www.chinaonline.com/topstories/000316/2/B200031501.asp>'.
- ____, 'China Banking Industry Assoc to Be Formed' (March 14, 2000), available at '<http://www.chinaonline.com/topstories/000314/2/C00031009.asp>'.
- ____, 'China Allows Insurance Firms to Enlarge Funds' (March 14, 2000), available at '<http://www.chinaonline.com/topstories/000313/11.asp>'.
- ____, 'Renminbi Exchange Rate to Remain Stable — China Central Banker' (March 7, 2000), available at '<http://www.chinaonline.com/topstories/000306/7.asp>'.
- ____, 'China Approves 7 More Foreign Banks for Renminbi Ops' (March 6, 2000), available at '<http://www.chinaonline.com/topstories/000306/2/C00030301.asp>'.
- ____, 'China Wuhan to Privatize 600 State Firms' (March 3, 2000), available at '<http://www.chinaonline.com/topstories/000303/2/C00030102.asp>'.
- ____, 'China 1999 GDP +7.1%, State Statistical Bureau' (March 2, 2000), available at '<http://www.chinaonline.com/topstories/000302/2/C00022906.asp>'.

- _____, 'China to Introduce Credit Information Mgmt System' (February 29, 2000), *available at 'http://www.chinaonline.com/topstories/000229/2/C00022407.asp'*.
- _____, 'China Shuttles Hainan Hong Kong & Macao Trust' (February 29, 2000), *available at 'http://www.chinaonline.com/topstories/000229/2/C00022810.asp'*.
- _____, 'China Everbright Buys Majority Stake in Shenyin Wanguo' (February 29, 2000), *available at 'http://www.chinaonline.com/topstories/000229/1/B200022807.asp'*.
- _____, 'China Securities Firms with US\$60.5m+ in Registered Capital', (February 22, 2000), *available at 'http://www.chinaonline.com/topstories/000222/b100021711.asp'*.
- _____, 'Four Asset Management Firms Open Shop in China's Wuhan' (February 18, 2000), *available at 'http://www.chinaonline.com/topstories/000218/2/C00021706.asp'*.
- _____, 'Hebi Mining Concludes Debt-to-Equity Swap' (February 17, 2000), *available at 'http://www.chinaonline.com/issues/econ_news/currentnews/secure/C00021601.asp'*.
- _____, 'China Stock Collateral Plan Unveiled with a Catch' (February 17, 2000), *available at 'http://www.chinaonline.com/industry/financial/currentnews/secure/B100021604.asp'*.
- _____, 'China Stock Exchanges Jump 9% on New Rules' (February 14, 2000), *available at 'http://www.chinaonline.com/topstories/000214/C00021430.asp'*.
- _____, 'China Sees Private Sector Upsurge Last Year' (February 9, 2000), *available at 'http://www.chinaonline.com/topstories/000209/2/C00020810.asp'*.
- _____, 'China Foreign Investment Fell More Than 11% in 1999' (February 8, 2000), *available at 'http://www.chinaonline.com/topstories/000208/2/b100012734.asp'*.
- _____, 'China Denies Debt-Equity Swaps Just "Word Games"' (February 7, 2000), *available at 'http://www.chinaonline.com/topstories/000207/2/C00012604.asp'*.
- _____, 'Shanghai Private Sector Skyrocketed Last Year' (February 4, 2000), *available at 'http://www.chinaonline.com/topstories/000204/2/c00020307.asp'*.
- _____, 'China Textile Sector Was Profitable in 1999' (February 4, 2000), *available at 'http://www.chinaonline.com/topstories/000204/2/b200012612.asp'*.
- _____, 'Private Ownership Jumps in China's Nanjing' (February 3, 2000), *available at 'http://www.chinaonline.com/topstories/000203/B100020249.asp'*.
- _____, 'China's Huarong AMC Signs Debt-Swap Accords with 7 SOEs' (February 3, 2000), *available at 'http://www.chinaonline.com/topstories/000203/2/C00020101.asp'*.
- _____, 'China Bans New Steel Mills, Pushes Industry-wide Closure' (February 3, 2000), *available at 'http://www.chinaonline.com/topstories/000203/2/B100020242'*.
- _____, 'Chinese Cities Move to Ease Money Flowing to State Firms' (February 2, 2000), *available at 'http://www.chinaonline.com/topstories/000202/2/B100013130.asp'*.
- _____, 'Beijing Airport to Launch Hong Kong IPO on Feb. 1' (January 31, 2000), *available at 'http://www.chinaonline.com/topstories/000131/c00013153.asp'*.
- _____, '"One or Two More Years" of Active Fiscal Policy for China, Minister' (January 31, 2000), *available at 'http://www.chinaonline.com/topstories/000131/B200012801.asp'*.

- ____, 'Wrap-up of China Co IPOs in HK so Far This Year' (January 27, 2000), *available at* ['http://www.chinaonline.com/topstories/000127/C00012006.asp'](http://www.chinaonline.com/topstories/000127/C00012006.asp).
- ____, 'China ICBC Profits Nearly US\$483 Mln in 1999' (January 27, 2000), *available at* ['http://www.chinaonline.com/industry/financial/currentnews/secure/C00012503.asp'](http://www.chinaonline.com/industry/financial/currentnews/secure/C00012503.asp).
- ____, 'China Great Wall Plans Debt-Equity Swaps with Five SOEs' (January 25, 2000), *available at* ['http://www.chinaonline.com/topstories/000125/c00012403.asp'](http://www.chinaonline.com/topstories/000125/c00012403.asp).
- ____, 'Dai Xianglong: China to Adopt Market Interest Rates' (January 24, 2000), *available at* ['http://www.chinaonline.com/topstories/000124/C00012003.asp'](http://www.chinaonline.com/topstories/000124/C00012003.asp).
- ____, 'Dai Xianglong: China's Commercial Banks Should Write Off 9% of Loans' (January 24, 2000), *available at* ['http://www.chinaonline.com/industry/financial/currentnews/secure/C00012004.asp'](http://www.chinaonline.com/industry/financial/currentnews/secure/C00012004.asp).
- ____, 'Dai Xianglong: Goals for 2000' (January 24, 2000), *available at* ['http://www.chinaonline.com/topstories/000124/C00012005.asp'](http://www.chinaonline.com/topstories/000124/C00012005.asp).
- ____, 'Dai Xianglong Says RMB Will Be Stable, Beijing to Help Banks' (January 20, 2000), *available at* ['http://www.chinaonline.com/topstories/000120/c00012052.asp'](http://www.chinaonline.com/topstories/000120/c00012052.asp).
- ____, 'China's SOEs Earn US\$11bn Profits in 1999' (January 18, 2000), *available at* ['http://www.chinaonline.com/topstories/000118/C00011709.asp'](http://www.chinaonline.com/topstories/000118/C00011709.asp).
- ____, 'People's Bank of China Strengthens Computer Security' (January 17, 2000), *available at* ['http://www.chinaonline.com/topstories/000118/C000118/C00011708.asp'](http://www.chinaonline.com/topstories/000118/C000118/C00011708.asp).
- ____, 'More Securities Firms Allowed to Enter China's Interbank Mkt' (January 17, 2000), *available at* ['http://www.chinaonline.com/topstories/000117/B100011423.asp'](http://www.chinaonline.com/topstories/000117/B100011423.asp).
- ____, 'China to Abolish Rules Impeding Private Investment' (January 14, 2000), *available at* ['http://www.chinaonline.com/topstories/000114/B100011214.asp'](http://www.chinaonline.com/topstories/000114/B100011214.asp).
- ____, 'Only 5% of Social Welfare Needs Met in China, Official' (January 13, 2000), *available at* ['http://www.chinaonline.com/topstories/000113/C00011105.asp'](http://www.chinaonline.com/topstories/000113/C00011105.asp).
- ____, 'China's 1999 Tax Revenue Increased over 13%' (January 13, 2000), *available at* ['http://www.chinaonline.com/topstories/000113/C00011101.asp'](http://www.chinaonline.com/topstories/000113/C00011101.asp).
- ____, 'China's Debt -Equity Program Has Yet to Be Implemented' (January 13, 2000), *available at* ['http://www.chinaonline.com/topstories/000113/C00011330.asp'](http://www.chinaonline.com/topstories/000113/C00011330.asp).
- ____, 'China's Debt Expanding Too Quickly, Finance Vice Minister' (January 12, 2000), *available at* ['http://www.chinaonline.com/topstories/000112/B200010728'](http://www.chinaonline.com/topstories/000112/B200010728).
- ____, 'China to Roll out Rules for New High Tech Board' (January 10, 2000), *available at* ['http://www.chinaonline.com/topstories/000110/C00010706.asp'](http://www.chinaonline.com/topstories/000110/C00010706.asp).
- ____, 'Debt-Equity Can Mean Debt Amnesty in China, Expert' (January 6, 2000), *available at* ['http://www.chinaonline.com/topstories/000106/C00010630b.asp'](http://www.chinaonline.com/topstories/000106/C00010630b.asp).
- ____, 'China's Communist Party to Keep Watch over 163 Key SOEs' (January 4, 2000), *available at* ['http://www.chinaonline.com/issues/econ_news/currentnews/secure/C9123005b.asp'](http://www.chinaonline.com/issues/econ_news/currentnews/secure/C9123005b.asp).

- _____, 'China GDP +7.1% 1999, Private Business to Be Promoted 2000' (January 4, 2000), available at http://www.chinaonline.com/issues/econ_news/currentnews/secure/C00010420.asp.
- _____, 'China's Debt-to-equity Swaps Total US\$11bln' (January 3, 2000), available at http://www.chinaonline.com/issues/econ_news/currentnews/secure/C9123002.asp.
- _____, 'China Second Auto Works to Swap Debt for Equity' (January 3, 2000), available at <http://www.chinaonline.com/topstories/000103/C9123004.asp>.
- _____, '1999 Banner Year for China's Textile Industry' (January 3, 2000), available at <http://www.chinaonline.com/topstories/000103/B2-99122901.asp>.
- _____, 'Ten SOEs Signed Debt-to-equity Swaps in China' (December 30, 1999), available at <http://www.chinaonline.com/industry/financial/currentnews/secure/C9122903c.asp>.
- _____, 'Second Beijing SOE Swaps Its Debt for Equity' (December 30, 1999), available at <http://www.chinaonline.com/industry/financial/currentnews/secure/C9122903.asp>.
- _____, 'Random Audit Exposes Accounting Fraud in Most Chinese SOEs' (December 27, 1999), available at http://www.chinaonline.com/issues/econ_news/currentnews/secure/C9122305.asp.
- _____, 'China to Continue Tough Audit Policies in 1999' (December 23, 1999), available at http://www.chinaonline.com/industry/fina/...ive/Secure/1998/December/fn_b8122213.asp.
- _____, 'Foreign and Chinese Banks to Compete over Intermediary Transactions' (December 17, 1999), available at <http://www.chinaonline.com/industry/financial/currentnews/open/B9121441.SS.asp>.
- _____, 'China Everbright Group Ltd., Sun Life Plan Insurance JV in Tianjin' (December 17, 1999), available at <http://www.chinaonline.com/topstories/991217/B2-99121624.asp>.
- _____, 'No Coal in China's Stockings Next Year' (December 14, 1999), available at <http://www.chinaonline.com/topstories/991214/B2-99121326.asp>.
- _____, 'Shanghai Closer to Establishing High Tech Secondary Board' (December 14, 1999), available at <http://www.chinaonline.com/topstories/991214/C9121303.asp>.
- _____, 'China's Insurance Cos. to Invest 5% of Assets in Stock Market' (December 14, 1999), available at <http://www.chinaonline.com/topstories/991214/B2-99121305.asp>.
- _____, 'China to Shutter 140 Money Losing Sugar Mills' (December 14, 1999), available at <http://www.chinaonline.com/topstories/991214/b9120910.asp>.
- _____, 'Rising Deficit, Unemployment True Y2K Worries Inside China' (December 13, 1999), available at <http://www.chinaonline.com/topstories/991213/C9121004.asp>.
- _____, 'China's Gov't Insurance Agency to Set up Shanghai Branch' (December 13, 1999), available at <http://www.chinaonline.com/topstories/991213/B2-99121027.asp>.
- _____, 'China's Listed Firms Raised US\$51.5bn from Jan-Oct' (December 13, 1999), available at <http://www.chinaonline.com/topstories/991213/C9121330.asp>.

- _____, 'Chongqing Encourages Foreign Investment in State Firms' (December 10, 1999), available at '<http://www.chinaonline.com/topstories/991210/B9120827.asp>'.
- _____, 'China's Wuhan Plans to Mix State Firm Ownership' (December 10, 1999), available at '<http://www.chinaonline.com/topstories/991210/B9120909.asp>'.
- _____, 'China to Continue Active Fiscal Policy in 2000' (December 8, 1999), available at 'http://www.chinaonline.com/issues/econ_news/currentnews/secure/B9120821.asp'.
- _____, 'China to Cut Govt Stakes of Listed Cos Below 51%, Official' (December 7, 1999), available at '<http://www.chinaonline.com/topstories/991207/B2-99120601.asp>'.
- _____, 'Jinchuan Nonferrous Metals Inks Debt-to-equity Deal' (December 6, 1999), available at '<http://www.chinaonline.com/topstories/99120308-b.asp>'.
- _____, 'China First Auto Works, Shanghai Electric Sign Debt-To-Equity Deals' (December 6, 1999), available at '<http://www.chinaonline.com/topstories/991206/B2-99120208c.asp>'.
- _____, 'China Disclose First Two Firms to Sell State Shares' (December 6, 1999), available at '<http://www.chinaonline.com/topstories/991206/C9120630.asp>'.
- _____, 'China to Control Coal, Steel, and Sugar Output in 2000' (December 3, 1999), available at '<http://www.chinaonline.com/topstories/991203/C9120111.asp>'.
- _____, 'China Huarong to Relieve ICBC of Bad Loans Worth US\$42.3bn' (December 3, 1999), available at '<http://www.chinaonline.com/topstories/991203/B9120238.asp>'.
- _____, 'Shanghai's Small Businesses Loosen State-ownership Grip' (December 1, 1999), available at '<http://www.chinaonline.com/topstories/991201/C9112902.asp>'.
- _____, 'Ten Chinese Firms Chosen to Sell Government Equity' (November 30, 1999), available at 'http://www.chinaonline.com/issues/econ_news/currentnews/secure/C9113030.asp'.
- _____, 'WTO Entry to Hurt China's State-owned Commercial Banks', *Fin. Times* (November 29, 1999), available at '<http://www.chinaonline.com/industry/financial/currentnews/open/B9112403-SS.asp>'.
- _____, 'China SOEs Must Turnaround by Next Year- Official' (November 24, 1999), available at '<http://www.chinaonline.com/topstories/991124/b9112320.asp>'.
- _____, 'Chinese Economist Argue for State-Owned Bank Market Listing' (November 24, 1999), available at '<http://www.chinaonline.com/topstories/9912322.asp>'.
- _____, 'Unauthorized Debt-equity Swaps Are Void- Beijing' (November 23, 1999), available at '<http://www.chinaonline.com/topstories/991123/b9112231.asp>'.
- _____, 'For the First Time, China Auction off A Bad Asset' (November 23, 1999), available at '<http://www.chinaonline.com/topstories/99112202.asp>'.
- _____, 'The True State of Auto Finance in China Today' (November 23, 1999), available at '<http://www.chinaonline.com/topstories/991123/c9112351.asp>'.
- _____, 'Beijing to Shutter 860 Money-losing State Firms by Year's End' (November 23, 1999), available at '<http://www.chinaonline.com/topstories/991123/C9112206.asp>'.

- _____, 'Foreign Bank's RMB Business in China to Grow' (November 18, 1999), *available at* <http://www.chinaonline.com/topstories/991118/B2-99111707.asp>.
- _____, 'Beijing Reveals New Assets Valuation Rules' (November 17, 1999), *available at* <http://www.chinaonline.com/industry/financial/NewsArchive/Secure/1999/November/B2-99111603.asp>.
- _____, 'Merrill Lynch, Bank of China Weigh Joint Investment Bank' (November 16, 1999), *available at* <http://www.chinaonline.com/topstories/991116/C9111502.asp>.
- _____, 'China's Steel Giant Anshan In RMB 7 Bln Debt Swap' (November 16, 1999), *available at* <http://www.chinaonline.com/topstories/991117/C9111602.asp>.
- _____, 'China-U.S. Reach WTO Deal' (November 15, 1999), *available at* <http://www.chinaonline.com/issues/wto/currentnews/open/C9111521.asp>.
- _____, 'China Everbright Plans 18% Stake in Shengying Wangguo' (November 15, 1999), *available at* <http://www.chinaonline.com/topstories/991115/C9111107.asp>.
- _____, 'China Dalian Shipyard & Chemical Make Debt-for-equity Swaps' (November 15, 1999), *available at* <http://www.chinaonline.com/topstories/991115/C9111106.asp>.
- _____, 'China's AMCs Sign Largest Debt-Equity Deal Yet' (November 12, 1999), *available at* <http://www.chinaonline.com/topstories/991112/C9111001.asp>.
- _____, 'China's State-Owned Firms to Rent Idle Land' (November 11, 1999), *available at* <http://www.chinaonline.com/topstories/991111/C9110901.asp>.
- _____, 'Creditors of China's Gitic Object to Plan' (November 9, 1999), *available at* <http://www.chinaonline.com/topstories/C9110807.asp>.
- _____, 'China Construction Bank Move to Attract Transnational Firms' (November 9, 1999), *available at* <http://www.chinaonline.com/topstories/B2-99110829.asp>.
- _____, 'The Prospects for China's Foreign Fund- Raising Capability' (November 8, 1999), *available at* <http://www.chinaonline.com/industry/financial/currentnews/open/B2-99110326-SS.asp>.
- _____, 'China to Reduce State Shares in Publicly Traded Companies' (November 5, 1999), *available at* <http://www.chinaonline.com/industry/financial/currentnews/open/C9110408-SS.asp>.
- _____, 'China Rushing to Draft and Amend Economic Laws' (November 4, 1999), *available at* <http://www.chinaonline.com/topstories/B2-9910201.asp>.
- _____, 'China Cinda Asset Mgmt to Take Only 60% of CCB's Debt' (November 4, 1999), *available at* <http://www.chinaonline.com/topstories/B2-99110402.asp>.
- _____, 'China Great Wall Signs First Debt-for-equity Deal' (November 3, 1999), *available at* <http://www.chinaonline.com/topstories/C9110203%20.asp>.
- _____, 'Top Loss Makers in China: Food Processing, Coal and Textile Industries' (November 1, 1999), *available at* <http://www.chinaonline.com/topstories/C9102910.asp>.
- _____, 'China's Asset Mgmt Cos. Team up to Clear up Zhejiang Chemical's Debts' (November 1, 1999), *available at* <http://chinaonline.com/topstories/B9102944.asp>.

- _____, 'China Laid-off Workers Could Reach 14m this Year-Ministry' (October 29, 1999), available at '<http://www.chinaonline.com/topstories/C9102810.asp>'.
- _____, 'China to Sell off State Shares Worth US\$60 Mln' (October 27, 1999), available at '<http://www.chinaonline.com/topstories/c9102608.asp>'.
- _____, 'China's new Rules on Mergers Limit Gov't Interference' (October 27, 1999), available at '<http://www.chinaonline.com/topstories/c9102603.asp>'.
- _____, 'China to Strengthen Social Security Safety Net' (October 27, 1999), available at '<http://www.chinaonline.com/topstories/C9102505.asp>'.
- _____, 'U.S. Treas Sec Comments on China's Asset Mgmt Cos.' (October 27, 1999), available at '<http://chinaonline.com/topstories/c9102731.asp>'.
- _____, 'CNPC, Sinopec to Swap US\$3.6bn in Debt for Equity' (October 27, 1999), available at '<http://www.chinaonline.com/topstories/c9102605.asp>'.
- _____, 'China to Announce Auto Industry Reorganization by Year's End' (October 26, 1999), available at '<http://www.chinaonline.com/topstories/AUTO.asp>'.
- _____, 'China Dongfang AMC Signs First Debt-Equity Deal' (October 26, 1999), available at '<http://www.chinaonline.com/topstories/C9102508.asp>'.
- _____, 'GITIC Debts Lower, Liquidators Say' (October 25, 1999), available at '<http://www.chinaonline.com/topstories/C9102211.asp>'.
- _____, 'China's Bank Clean-up to Take Three Years- Official' (October 25, 1999), available at '<http://www.chinaonline.com/topstories/C9102114.asp>'.
- _____, 'Beijing Rolls out New Policies for China's Laid-off Workers' (October 21, 1999), available at '<http://www.chinaonline.com/topstories/C9102004.asp>'.
- _____, 'China's Fourth Asset Management Company Ready to Roll' (October 20, 1999), available at '<http://www.chinaonline.com/topstories/C9101903.asp>'.
- _____, 'China Unveils New Weapons in War on Deflation' (October 20, 1999), available at '<http://www.chinaonline.com/topstories/C9101904.asp>'.
- _____, 'China's SOE Sector Shrinks 14% in first Eight Months of 1999' (October 19, 1999), available at '<http://www.chinaonline.com/topstories/C91901930.asp>'.
- _____, 'China Gets Second Asset Mgmt Co., Two More this Week' (October 18, 1999), available at '<http://www.chinaonline.com/industry/financial/currentnews/secure/C9101508.asp>'.
- _____, 'China Gets Third Asset Management Co., Another Wednesday' (October 18, 1999), available at '<http://www.chinaonline.com/topstories/B2-99101805.asp>'.
- _____, 'China to Allow Stock Buybacks, State-Owned Equity Sell-offs' (October 15, 1999), available at '<http://www.chinaonline.com/topstories/B2-991-501.asp>'.
- _____, 'China Issues New Health Care Regulations' (October 13, 1999), available at '<http://www.chinaonline.com/industry/healthcare/currentnews/secure/C9100706-SS.asp>'.
- _____, 'China's Central Banker Talks up Bank, Interest Rate Reform' (October 12, 1999), available at '<http://www.chinaonline.com/topstories/C9101109.asp>'.

- ____, 'China's CAMCO Tackles Debt of 2 Shangdong SOEs' (October 11, 1999), *available at 'http://www.chinaonline.com/topstories/C9100810.asp'*.
- ____, 'PBOC Grants Insurance Cos Access to Interbank Lending Mkt' (August 30, 1999), *available at 'http://www.chinaonline.com/top_stories/b2_99082525'*.
- ____, 'Debt-for-Equity Deal for Hainan's Troubled Trusts' (August 10, 1999), *available at 'http://www.chinaonline.com/industry/fina...sArchive/Secure/1999/august/c9080915.asp'*.
- ____, 'Car Loans Gaining Popularity in China' (October 6, 1999), *available at 'http://www.chinaonline.com/topstories/c9100507.asp'*.
- ____, 'Dozens of Shanghai SOEs Plan Debt-for-Equity Swaps' (October 4, 1999), *available at 'http://www.chinaonline.com/topstories/C9092909.asp'*.
- ____, 'China Must Reform Financial Sector, Privatize Banks- Economist David Hale' (October 1, 1999), *available at 'http://www.chinaonline.com/topstorie/C9100153.asp'*.
- ____, 'PBOC Rate Cut Good for Mid-Sized Firms- China Food Co.' (September 30, 1999), *available at 'http://www.chinaonline.com/topstories/C9093023.asp'*.
- ____, 'Consumer Bankcards on the Rise in China' (September 28, 1999), *available at 'http://www.chinaonline.com/topstories/B2-99092404-S.asp'*.
- ____, 'ICBC Tele-banking Now Available China-wide' (September 27, 1999), *available at 'http://www.chinaonline.com/topstories/C9092405.asp'*.
- ____, 'China Reiterates Goal to Make SOEs Profitable in Three Years' (September 24, 1999), *available at 'http://www.chinaonline.com/topstories/C9092211.asp'*.
- ____, 'Shanghai Pudong Bank IPO in Progress' (September 23, 1999), *available at 'http://www.chinaonline.com/topstories.com/C9092330.asp'*.
- ____, 'Brokerages in China Allowed to Enter Interbank, Bond Markets' (September 23, 1999), *available at 'http://www.chinaonline.com/topstories/c9092218.asp'*.
- ____, 'Deposits Exceed Loans in China: An Expert Analysis' (September 23, 1999), *available at 'http://www.chinaonline.com/industry/financial/currentnews/open/C9091606.asp'*.
- ____, 'China Pledges to Modernize SOEs by Next Year' (September 22, 1999), *available at 'http://www.chinaonline.com/topstories/C9092110.asp'*.
- ____, 'China's Central Bank Extends Mortgage Period, Cuts Rates to Stimulate Home Sales' (September 22, 1999), *available at 'http://www.chinaonline.com/topstories/C9092115.asp'*.
- ____, 'Gerling Insurance Allies with GITIC' (September 22, 1999), *available at 'http://www.chinaonline.com/topstories/B2_99092026.asp'*.
- ____, 'Shanghai Pudong Bank to List on China's A-Share Market' (September 21, 1999), *available at 'http://www.chinaonline.com/topstories/C9092011.asp'*.
- ____, 'Economic Examines China's Potential Debt-to-equity Conversion' (September 21, 1999), *available at*

'http://www.chinaonline.com/industry/fina.../currentnews/open/B2-99090711-SS.doc.asp'.

- ____, 'Reform Package for China's SOEs Outlined' (September 21, 1999), *available at* *'http://www.chinaonline.com/topstories/C9092131.asp'.*
- ____, 'China's CAMCO to Tackle Debts of Fertilizer Plant' (September 21, 1999), *available at* *'http://www.chinaonline.com/topstories/C9092130.asp'.*
- ____, 'China's Largest Oilfield Restructures' (September 20, 1999), *available at* *'http://www.chinaonline.com/topstories/C9091705.asp'.*
- ____, 'People's Appliances Group to Acquire 34 SOEs' (September 20, 1999), *available at* *'http://www.chinaonline.com/topstories/C9091706.asp'.*
- ____, 'CAMCO Assists Meishan in Debt-for-equity Swap' (September 20, 1999), *available at* *'http://www.chinaonline.com/topstories/c9091702.asp'.*
- ____, 'Review of China's 3Q Money Market' (September 17, 1999), *available at* *'http://www.chinaonline.com/issues/econ_news/currentnews/open/B9111534-SS.asp'.*
- ____, 'China to Launch new Postal Savings Bank' (September 17, 1999), *available at* *'http://www.chinaonline.com/topstories/C9091604.asp'.*
- ____, 'Listed Stocks in China Break 1,000 Mark' (September 15, 1999), *available at* *'http://www.chinaonline.com/topstories/C9091410.asp'.*
- ____, 'China's CCB Makes Unprecedented RMB Loan to Foreign Bank' (September 15, 1999), *available at* *'http://www.chinaonline.com/topstories/C9091415.asp'.*
- ____, 'Private Firms in Guangdong Allowed to Buy into State-Sector' (September 14, 1999), *available at* *'http://www.chinaonline.com/topstories/C9090914'.*
- ____, 'SOE Listing Rules Cause Market Surge in China' (September 13, 1999), *available at* *'http://www.chinaonline.com/topstories/C9090810.asp'.*
- ____, 'IFC Takes 5% Stake in Bank of Shanghai' (September 13, 1999), *available at* *'http://www.chinaonline.com/topstories/B9091009.asp'.*
- ____, 'China May Sell over 15% of SOE Stakes' (September 13, 1999), *available at* *'http://www.chinaonline.com/topstories/C9091016.asp'.*
- ____, 'Gzitic to Set up Joint-Venture Bank with Foreign Creditors' (September 10, 1999), *available* *at* *'http://www.chinaonline.com/industry/fina...sArchive/Secure/1999/august/c9080918.asp'.*
- ____, 'China Bank of Communications Severs Ties with Insurance, Securities Firms' (September 9, 1999), *available* *at* *'http://www.chinaonline.com/top_stories/b2_99090619.asp'.*
- ____, 'China's Entry Into WTO: A Challenge for the Country's Banking System' (September 8, 1999), *available* *at* *'http://www.chinaonline.com/industry/financial/currentnews/open/b2_990831261.asp'.*

- ____, 'Transnational Banks Show Limited Influence in China' (September 3, 1999), available at http://www.chinaonline.com/industry/financial/currentnews/open/b2_99081714s.asp.
- ____, 'China's Mensheng Bank Plans IH2000 IPO' (September 3, 1999), available at http://www.chinaonline.com/top_stories/c9090209.asp.
- ____, 'Ag Bk of China: Citibank's Agent for RMB Transactions' (September 3, 1999), available at http://www.chinaonline.com/top_stories/c9083118.asp.
- ____, 'China's Banks Build Bridges to Insurance Firms' (August 26, 1999), available at http://www.chinaonline.com/top_stories/c9082411.asp.
- ____, 'China Issues Government Bonds to Recapitalize Banks' (August 26, 1999), available at http://www.chinaonline.com/industry/fina...hive/Secure/1998/August/fn_b8082509.asp.
- ____, 'Credit Assessment Organizations in China: A Saga of Problems and Hopes' (August 25, 1999), available at http://www.chinaonline.com/industry/fina...hive/Secure/1999/august/b2_99080624s.asp.
- ____, 'Citibank China Gets First Medium-Term RMB Loan' (August 25, 1999), available at http://www.chinaonline.com/top_stories/c9082415.asp.
- ____, 'Foreign Banks in Shenzhen to Provide RMB Transactions' (August 11, 1998), available at http://www.chinaonline.com/industry/fina...hive/Secure/1998/August/fn_b8081213e.asp.
- ____, 'Foreign Banks in China Extend RMB Operations' (August 6, 1999), available at <http://www.chinaonline.com/industry/fina...sArchive/Secure/1999/august/c9080514.asp>.
- ____, 'Easier Loans for China's Struggling State Firms' (August 3, 1999), available at http://www.chinaonline.com/top_stories/c9080212.asp.
- ____, 'China Construction Bank Reforms Auditing System' (July 27, 1999), available at http://www.chinaonline.com/industry/fina...Archive/Secure/1999/fn_c9072215.asp.
- ____, 'China Updates Overseas Listing Rules' (July 20, 1999), available at http://www.chinaonline.com/industry/fina...Archive/Secure/1999/july/fn_c9071916.asp.
- ____, 'State-Owned Commercial Bank Reform in China Will Lead to Branch Closures, Layoffs' (May 27, 1999), available at http://www.chinaonline.com/industry/fina...sArchieve/Secure/1999/may/fn_c9052612.asp.
- ____, 'The Spectacular Rise and Fall of Gitic' (May 18, 1999), available at http://www.chinaonline.com/top_stories/breakingnews_b2_99051423.html.

- ____, 'China's Foreign Debt Increased 11% to US\$146bn in 1998' (May 14, 1999),
available at http://www.chinaonline.com/top_stories/breakingnews_b2_99050411s.html.
- ____, 'China's Securities Market Value US\$237 Billion - Regulator' (May 13, 1999),
available at http://www.chinaonline.com/top_stories/breakingnews_c9051214.html.
- ____, 'Financial Sector in China "Too Immature" to Face Foreign Competition' (May 11,
1999), available at http://www.chinaonline.com/top_stories/breakingnews_b9042907s.html.
- ____, 'China Should Set Economic Growth Rate Floor at 7%, Economist Says' (May 7,
1999), available at http://www.chinaonline.com/top_stories/breakingnews_b2-99050518.
- ____, 'Proposals to Replace Tolls with Gas Taxes Thwarted by China's Congress, For Now'
(May 3, 1999), available at http://www.chinaonline.com/top_stories/breakingnews_c9043007.html.
- ____, 'China to Continue Global Bank Sales in 1999, Finance Minister Says' (May 3, 1999),
available at http://www.chinaonline.com/top_stories/breakingnews_c9043004.html.
- ____, 'Key Monetary and Economic Policy Goals for 1999 Outlined in Government Report'
(April 30, 1999), available at http://www.chinaonline.com/top_stories/breakingnews_b299042904.html.
- ____, 'Wu Warns U.S. Negotiators Against Brinkmanship Policy During WTO Talks' (April
28, 1999), available at http://www.chinaonline.com/top_stories/breakingnews_c9042821.html.
- ____, 'The Impact of WTO Membership on Domestic Businesses in China' (April 26, 1999).
available at http://www.chinaonline.com/top_stories/breakingnews_C9042303.html.
- ____, 'China Establishes a New Company to Manage Bad Bank Assets' (April 22, 1999),
available at http://www.chinaonline.com/top_stories/breakingnews_c9042003.html.
- ____, 'New Definitions Reduce Number of Large, Money Losing SOEs - On Paper, at Least'
(April 21, 1999), available at http://www.chinaonline.com/top_stories/breakingnews_b9041933.html.
- ____, 'New Approval System for China Offshore Bond Issuances' (April 19, 2000),
available at <http://www.chinaonline.com/topstories/000419/2/B200041303.asp>.
- ____, 'China Sets New Procurement Rules to Curb SOE Waste, Corruption' (April 19,
1999), available at http://www.chinaonline.com/top_stories/breakingnews_c9041603.html.
- ____, 'Changchun Auctions China's Largest Pharmaceutical Plant for Bankruptcy' (April 19,
1999), available at http://www.chinaonline.com/top_stories/breakingnews_c9041601.html.
- ____, 'China Development Bank to Issue Inter-Bank Short-Term Loans' (April 19, 1999),
available at http://www.chinaonline.com/top_stories/breakingnews_c9041605.html.

- ____, 'A Look at Bank Reform in China' (April 14, 1999), available at http://www.chinaonline.com/top_stories/breakingnews_b2-99030914-2.html.
- ____, 'Evolution of China's Central Bank Regional Branch System' (January 27, 1999), available at http://www.chinaonline.com/top_stories/today_b2_99011918.html.
- ____, 'China's SOEs Warned to Honor Debts Owed to State Banks' (December 29, 1998), available at http://www.chinaonline.com/industry/fina...ive/Secure/1998/December/fn_b8122203.asp.
- ____, 'Shanghai Company Receives First Reminbi Currency Syndicated Loan' (December 23, 1998), available at http://www.chinaonline.com/industry/fina...ive/Secure/1998/December/fn_c8122303.asp.
- ____, 'China's Reform Cut into Bank Profits' (December 22, 1998), available at http://www.chinaonline.com/industry/fina...ive/Secure/1998/December/fn_b8121707.asp.
- ____, 'China Further Opens Financial Sector- But Capital Account to Remain Closed' (December 2, 1998), available at http://www.chinaonline.com/industry/fina...ive/Secure/1998/December/fn_b8120101.asp.
- ____, 'China to Establish Insurance Regulatory Body' (November 19, 1998), available at http://www.chinaonline.com/industry/fina...ive/Secure/1998/November/fn_b8111903.asp.
- ____, 'China's Central Bank Raises Ceiling on Small Business Loan Interest Rates' (November 4, 1998), available at http://www.chinaonline.com/industry/fina...ive/Secure/1998/November/fn_b8103036.asp.
- ____, 'Financial Sector Opening to Foreign Firms at "Appropriate" Rate, China Says' (October 20, 1998), available at http://www.chinaonline.com/fina...hive/1998/October/fn_b8102022.asp.
- ____, 'China Approves Regulatory Body for Securities Sector' (October 20, 1998), available at http://www.chinaonline.com/industry/financialArchive/Secure/1998/October/fn_c8102006.asp.
- ____, 'Chinese Domestic Insurance Cos to Trade on Interbank Mkt' (October 16, 1998), available at http://www.chinaonline.com/industry/fina...hive/Secure/1998/October/fn_b8101603.asp.
- ____, 'China Allows RMB Loans Between Local and Foreign Banks' (September 5, 1998), available at http://www.chinaonline.com/industry/fina...ve/Secure/1998/September/fn_b8090404.asp.

- _____, 'China Establishes High-Level Banking Oversight Committee' (June 23, 1998), *available at*
'http://www.chinaonline.com/fina...rchive/Secure/1998/June/fn_c8062302e.asp'.
- _____, 'China's Commercial Banks Lend to State-Owned Enterprises' (June 12, 1998), *available at*
'http://www.chinaonline.com/industry/fina...wsArchive/Secure/1998/May/fn_8052611.asp'.
- _____, 'China's Central Bank Governor on Financial Situation' (March 7, 1998), *available at*
'http://www.chinaonline.com/industry/fina...l/NewsArchive/Secure/1998/May/fn_002.asp'.
- Cho, Namju, 'South Korea Pitches to Sell Bad Assets', *Dow Jones News Service* (March 26, 1999).
- Chu, Vivian, 'Korea's Kookmin Debuts Own NPL-Backed Bond', *Emerging Mkts. Debt Rep.* (December, 13 1999), *available at '1999 WL 26056658'*.
- Combined Business News, 'Workout Programs Face Crisis Amid Rising Conflict Between Banks and Cos.', *available at '1999 WL 10511584'*.
- Dow Jones Business News, 'Japan's Financial Watchdog Loosens Rules on Bad Debts, Loss Reserves' (April 8, 1999).
- _____, 'Japan's Bank of Yokohama Said Planning 21% Cut in Group Work Force' (April 6, 1999).
- Dow Jones International News, 'Chinese Official Says Time Not Yet Right to Privatize Bks' (December 6, 1999).
- _____, 'China Asset Management Companies, Devt Bk Sign First Joint Debt Deal' (October 29, 1999).
- _____, 'Japan LTCB Window-Dressed FY97 Data to Hide Losses-Kyodo' (April 3, 1999).
- _____, 'Malaysia Bk Rules To Help Bad Loans But Hurt Regional Hopes' (April 1, 1999).
- _____, 'Thai Ctrl Bk: Details on Problems Loan Reclassification', (April 1, 1999).
- _____, 'Japan Launches New Govt. Body to Recover Banks' Bad Loans' (April 1, 1999).
- _____, 'Cap Adequacy Ratio for 17 Largest Japan Bks over 10%-Nikkei' (March 31, 1999).
- _____, 'China Construction Bk Postpones Xinda Establishment', (March 26, 1999).
- _____, 'Japan's Tokyo Tomin Bank to Sell HQ, Close Nonbank Affiliate' (March 25, 1999).
- _____, 'China Pledges Tough Measures to Combat Bad Loans - Report' (March 19, 1999).
- _____, 'China Banker/BKs' Bad Debt: Seeks New Legal Framework' (March 8, 1999).
- Dow Jones News Service, 'Japan's Nichiboshin Gains Debt Waiver; Still Excess Debt' (April 5, 1999).
- _____, 'Japan Body to Set Prices for Bad Loans at Sound Banks' (March 31, 1999).
- _____, 'Japan LTCB Used Secret Criteria to Classify Loans - Kyodo' (March 29, 1999).

- _____, 'South Korea Asset Management on U.S. Road Show For Bad Loans' (March 20, 1999).
- Earnest & Young International, *Asia Pacific Economic Outlook: 1999-2009* (1999).
- Ekin, Thomas C., 'The United States Legal Lending Limit and National Bank Loans to Foreign Governments, Their Agencies, and Instrumentalities', *Mimeo, Office of the Comptroller of the Currency* (1978).
- Fan, Gang, 'China's Deflation: The Answer is Not "Save Less, Spend More", But Release Credit to the Private Sector', *Chinaonline* (August 2, 1999), available at 'http://www.chinaonline.com/commentary_analysis/ca_c9072863_s_nn.html'.
- Fernald, John G. & Babson, Oliver D., 'Why Has China Survived the Asian Crisis So Well? What Risks Remain?' *Board of Governors of the Federal Reserve System International Finance Discussion Papers* No. 633 (February 1999).
- Fischer Stanley, 'Learning the Lessons of Financial Crises: The Roles of the Public and Private Sectors', *Speech at the Emerging Market Traders' Association Annual Meeting New York* (December 9, 1999), available at '<http://www.imf.org/external/np/speeches/1999/120999.HTM>'.
- Fukushima, Mutsuo, 'FSA's New Loan-Loss Reserve Rules Called Too Lenient', *Japan Economic Newswire* (April 9, 1999).
- Gardener, E. P. M., 'Towards European Financial Supermarket?' *Institute of European Finance Research Papers in Banking and Finance*, RP 90/9, Bangor (1990).
- Gesteland, Lester J., 'S & P's China Downgrade Agrees with Japan's MOF', *Chinaonline* (August 3, 1999), available at 'http://www.chinaonline.com/top_stories/c9080350.asp'.
- Gooch, Anthony C., and Linda B. Klein, 'Sample Annotated Loan Agreement for Syndicated Eurodollar Transaction', *Euromoney Financial Law documentation Series, London: Euromoney Publications* (1986).
- Hong Kong Standard, 'BOC Profits Plunge 36pc' (March 18, 1999), available at '1999 WL 5641324'.
- IIF, 'Bankers Propose Review of Bank Credit Risk Capital Framework', *IIF Press Release* (March 23, 1998).
- IRASIA, 'CITIC Enterprises Limited', available at '<http://www.irasia.com/listco/hk/gitic/profile.htm>'.
- Jackson, P.C., 'Address before the Alabama Bankers Association', *Mobile, Alabama, Board of Governors of the Federal Reserve System, Washington, D.C.* (May 11, 1978).
- Jakarta Post, 'Legislators Urge Govt Probe of Bad Debtors', available at '1999 WL 5634248'.
- _____, 'Resolving Bad Loans', available at '1999 WL 5634226'.
- _____, 'Investors Express "Bullish" Tone on Indonesia' (May 12, 1999), available at '1999 WL 5636248'.
- _____, 'State Banks' Subterfuge' (May 11, 1999), available at '1999 WL 5635209'.

- James McCormack, *The Japanese Way: The Relationship Between Financial Institutions and Non-Financial Firms*, Department of Foreign Affairs and International Trade of Canada Policy Staff Paper No. 94/16 (June 1994).
- Jao, Y. C., 'Financial Reform in China and Hong Kong 1987-1988: A Comparative Overview', *Paper presented to the Inaugural International Conference on Asian Pacific Financial Markets* (Singapore: 16-18 Nov. 1989).
- Japan Economic Newswire, 'FSA Unveils Easier Bad-Loan Criteria to Spur Lending' (April 8, 1990).
- _____, 'RCC Not to Pursue Lender's Responsibility, Nakabo Says' (April 1, 1999).
- _____, 'LTCB Had Capital Deficit of 2.5 Tril. Yen in Oct.' (March 18, 1999).
- Japan Weekly Monitor, 'FRC to Keep Urging Major Banks to Promote Restructuring' (May 3, 1999), *available at '1999 WL 8897362'*.
- Jayasankaran, S., 'Review: Malaysia Drags Its Feet on Restructuring Ailing Cos', *Dow Jones News Service* (March 31, 1999).
- JiJi Press English News Service, 'RCC Ready to Buy 5 Trillion Yen in Bad Loans from Healthy Banks: Kioi' (September 3, 1999), *available at '1999 WL 23626466'*.
- Kit Marlow, 'China's CAMCO Begins Mammoth Task of Recovering Bank Debt', *Chinaonline News* (September 7, 1999), *available at 'http://www.chinaonline.com/top_stories/c9090730.asp'*.
- Krugman, P. 'What Happened to Asia?' mimeo (January 1998), *available at 'http://web.mit.edu/krugman/www/DISNTER.html'*.
- Kwan Chooi Tow, 'China Construction Bank Still Preparing for Asset Management Firm', *Agency France-Press* (April 8, 1999), *available at '1999 WL 2579486'*.
- _____, 'State Council's China Everbright Takes Over China Investment Bank', *Agence France-Presse* (March 18, 1999), *available at '1999 WL 2566180'*.
- Macmahon, William J., 'Everbright and CIB Merge in a Strong Bank-Weak Bank Rescue', *available at 'http://www.chinaonline.com/top_stories/breakingnews_b9031915.html'*.
- Marlow, Kit, 'A Week of Praise and Promises For China's SOE Reformers', *Chinaonline News* (August 6, 1999), *available at 'http://www.chinaonline.com/top_stories/c9080530.asp'*.
- Mellyn & Saal, 'A Perspective on the Risk and Regulatory Implications of Market-Centric Financial Systems', *First Price Essay of the 1998 Essay Competition of the IIF*.
- Miller, H. Lyman, 'China Regrouping: Significance of State Council Reorganization', *available at 'http://www.chinaonline.com/Csubs/econ_news/en_10.asp'*.
- Moody's Investors Service, *Banking System Outlook: Singapore* (July 1999).
- Murphy, Dan, 'Review/Indonesia: Vital Bank Restructuring Slows to A Crawl', *Dow Jones News Service* (April 14, 1999).
- Nakamae, Naoko & Abrahams, Paul, 'LTCB: Ripplewood Set to Buy State Bank', *Fin. Times* (September 28, 1999).

- Neoh, Anthony, 'China's Domestic Capital Markets in the New Millenium' (August 21, 2000), available at http://www.chinaonline.com/commentary_an...onomics/currentnews/secure/c00082143.asp.
- Nissan New Release, 'Nissan Unveil Revival Plan' (October 18, 1999), available at <http://www.nissan.co.jp/NRP/NEWS/news-e.html>.
- Norton, Joseph J., 'International Financial Crises: Implications for Financial Stability in China', *presented for 100th Anniversary of Peking University* (May, 1998).
- Pu, Yonghao, 'Why China Won't Be Asia's Next Basket Case Economy', available at http://www.chinaonline.com/top_stories/breakingnews_c9041941.html.
- _____, 'How to Save China From Oversaving', *Chinaonline* (June 28, 1999), available at http://www.chinaonline.com/commentary_analysis/ca_c9062521.html.
- _____, 'China's New Challenge: Deflation', *Chinaonline* (May 11, 1999), available at http://www.chinaonline.com/CSubs/econ_news/en_c81102Pu.asp.
- Reuters English News Service, 'South Korea: KAMCO Plans to Issue Four Trillion Won ABS in 2000' (December 16, 1999).
- _____, 'South Korea: S. Korea KAMCO to Issue 265bn Won ABS on Dec. 27' (December 15, 1999).
- _____, 'China: China's Shangdong Ruyi \$34.9m Debt/Equity Swap' (December 14, 1999).
- _____, 'China: Analysis-China Bonds Plan Sparks Payment Worries' (December 9, 1999).
- _____, 'China: Two Chinese SOEs in 2.5 Bln Yuan Debt-equity Swaps' (November 11, 1999).
- _____, 'China: China's Great Wall Inks \$72m Debt-Equity Swap' (November 2, 1999).
- Richard Jerram, 'Half Measures Hobble Japan's Recovery', *Asian Wall St. J.*, 10 (May 11, 1999).
- Roberson, Ross, *The Comptroller and Bank Supervision*, Washinton D.C.: Office of the Comptroller of Currency 59-61 (1968).
- S & P CreditWire, 'China's Foreign Currency Rating Lowered to "BBB"; Outlook Stable' (July 21, 1999), available at <http://www.standardpoor.com/ratings/news/china.htm>.
- S & P's Ratings Service, 'Remarks By Leo C. O'Neill, President and Chief Rating Office, Standards & Poor's Ratings Services (Tokyo, February 1999)', available at <http://www.ratings.Standardpoor.com/news/leospeech2.htm>.
- Shearman & Sterling, 'The Gramm-Leach-Bliley Act', *Client Publication* (December 1999).
- Standard & Poor's CreditWire, 'Ratings Lowered on Five Chinese Financial Institutions; Romoved from CreditWatch Negative', available at <http://www.ratings.standardpoor.com/news/newsrelease.htm>.
- Standard Chartered, 'Standard Chartered to Acquire Control of Bank Bali', available at <http://www.standardchartered.com/scb/an/bankbali.html>.

- Tarrant, Bill, 'South Korea: Analysis- Skorea Shifts to Tack on Asset Restructuring', Reuters English News Service (November 2, 1999).
- Tett, Gillian & Nakamae, Naoko, 'Ripplewood: Profit Target Set for LTCB', *Fin. Times* (September 29, 1999).
- Tett, Gillian, 'Sun Finally Rising on Japanese Banks: If Japan's Economy is to Show New Signs of Life, Banks' Bad Loans Must Be Written off More Rapidly', *National Post* (March 20, 1999), available at '1999 WL 13668538'.
- The Association Press, 'China's Central Bank Chief Says China Will Make Concessions on WTO', *Associated Press Newswires* (March 11, 1999).
- The Economist, 'Problems Left Over from History' (December 11, 1999), available at '1999 WL 29811960'.
- The Korea Herald, 'KAMCO Sells Nonperforming Loans for Handsome Profits' (December 10, 1999), available at '1999 WL 29057797'.
- _____, 'Korea Development Bank to Set up Asset Management Unit' (December 6, 1999), available in '1999 WL 29057585'.
- _____, 'Greatly Improving Debt-Equity Ratios Key to Corporate Reform' (November 10, 1999), available at '1999 WL 29056731'.
- _____, 'Kamco Optimistic about Selling Bad Assets to Global Investors' (May 8, 1999), available at '1999 WL 17748886'.
- Timmermans, Jeffrey, 'Korea Asset Mgmt to Dispose of KRW 16t Bad Debt This Yr', *Dow Jones International News* (March 30, 1999).
- Tirole, J, *The Internal Organization of Government*, Oxford Economic Papers (1993).
- Vanikkll, Krirk, 'Thai Economic Crisis from the Prospective of a Lawyer', *Speech delivered at Queen Mary and Westfield College, London* (December 1998).
- World News Connection, 'Institutional Innovation — Key to Reform of State-Owned Enterprises' (September 19, 1999), available at '1999 WL26443726'.
- _____, Article by ZXS reporter Tao Guangxiong: 'Focus of State-Owned Enterprise Reform: Converting Debts into Shares Helps Ease Difficulties in State-Owned Enterprise Reform' (September 18, 1999), available at '1999 WL26443497'.
- _____, ZXS Reporter Liu Yusheng on the focal point of SOE reform: 'The Fundamental Policies Have Been Set, The Key Lies in Implementation' (September 19, 1999), available at '1999 WL 26444054'.
- _____, Xinhua comments on Enterprise Reform, Xinhua reporters Sun Jie and Lu Peng: 'Thousands of Sailing Boats Are Competing With Each Other — Commenting on the Situation of the Reform and Development of State-Owned Enterprises' (September 16, 1999), available at '1999 WL26444186'.
- _____, Article by ZXS reporter Zhao Shengyu: 'Focus on Reform of State-Owned Enterprises: Can China's State-owned Enterprises Get Out of Predicaments in Three Years?' (September 16, 1999) available at '1999 WL26444041'.

- _____, 'LTCB Hid "Mess" in Finance Ministry Rules' (May 11, 1999), *available at '1999 WL 18735840'*.
- Wu, Renhong, *China's Economic Outlook*, Chinaonline (1999).
- Xinhua English Newswire, 'Bangkok Bank Boosts Capital Adequacy Ratio' (April 7, 1999), *available '1999 WL 7932277'*.
- _____, 'China's Bank Loans On Target' (April 5, 1999), *available at '1999 WL 7931582'*.
- _____, '11.5 Bln Dollars in Indonesia Bad Bank Assets Seized' (April 3, 1999), *available at '1999 WL 7931247'*.
- _____, 'China Will Not Suffer A Financial Crisis: Official', (April 3, 1999), *available at '1999 WL 7931322'*.
- _____, 'News Analysis: Asian to See More Bank Mergers' (April 2, 1999), *available at '1999 WL 7931082'*.
- Xinhua News Agency, 'SOEs Sign Huge Debt-Equity Swap Agreements' (November 11, 1999), *available at '1999 WL 7309142'*.
- _____, 'China Wages Full War on Bad Assets of Banking Sector' (October 20, 1999), *available at '1999 WL 7308529'*.
- _____, 'Full Text of Communiqué of 4th Plenum of CPC Central Committee (3)' (September 23, 1999).
- _____, '"Converting Debts into Shares", An Important Form of SOE Reform' (September 3, 1999), *available at '1999 WL 7397282'*.
- _____, 'China's Banking Reform Yields Results: IFC Official' (May 14, 1999), *available at '1999 WL 7303805'*.
- _____, 'China Opens First Asset Management Company' (April 21, 1999), *available at '1999 WL 7303136'*.
- _____, 'Financial System Reform to Move into New Stages', (April 2, 1999), *available at '1999 WL 7302553'*.
- Xinhua, 'S. Korea's Non-performing Debts down to 51 Billion U.S. Dollars' (December 9, 1999), *available at '1999 WL 30153908'*.

V. OFFICIAL DOCUMENTS

BANK FOR INTERNATIONAL SETTLEMENTS ("BIS")

Banking Crises in Emerging Economies: Origins and Policy Options, BIS Economic Papers No. 46, by Goldstein, Morris & Turner, Philip (1999).

Strengthening the Banking System in China: Issues and Experience, BIS Policy Papers No. 7 (October, 1999).

Bank Restructuring in Practice, BIS Policy Papers No. 6 (August 1999).

Report on OTC Derivatives: Settlement Procedures and Counterparty Risk Management (September 1998).

Precarious Credit Equilibria: Reflections on the Asian Financial Crisis, BIS Working Papers No. 64, by Joseph, Bisignano (March 1999).

BIS 66th Annual Report (Basle, 1996).

BASLE COMMITTEE ON BANKING REGULATION AND SUPERVISORY PRACTICES (NOW BASLE COMMITTEE ON BANKING SUPERVISION)

Banks' Interactions with Highly Leveraged Institutions: Implementation of the Basle Committee's Sound Practices Paper (January 2000).

Update on Work on a New Capital Adequacy Framework (November 1999).

Sound Practices for Loan Accounting and Disclosure (July 1999).

A Capital Adequacy Framework (June 1999).

Recommendations for the Public Disclosure of Trading and Derivatives Activities of Banks and Securities Firms, joint consultative paper with ISOCO (February 1999).

Basle Committee on Banking Supervision & Technical Committee of the International Organization of Securities Commission, Framework for the Supervisory Information about Derivatives and Trading Activities (September 1998).

Enhancing Bank Transparency (September 1998).

Joint Forum on Financial Conglomerates, Supervision of Financial Conglomerates, consultation documents released by the Basle Committee on Banking Supervision (February 1998), available at '<http://www.bis.org/publ/bcbs34.htm>'.

Core Principles for Effective Banking Supervision (September 1997).

Amendment to the Capital Accord to Incorporate Market Risks (January 1996).

Framework for Supervisory Information About the Derivatives Activities of Banks and Securities Firms (May 1995).

Basle Capital Accord: Treatment of Potential Exposure for Off-Balance Sheet Items (April 1995).

Measuring and Controlling Large Credit Exposure (1991).

International Convergence of Capital Measurement and Capital Standards (July 1988) (the "Capital Accord").

EUROPEAN BANK FOR RECONSTRUCTING AND DEVELOPMENT (EBRD)

Transition Report 1998: Financial Sector in Transition (1998).

INTERNATIONAL MONETARY FUND (IMF)

Interventions in Banks During Banking Crises: The Experience of Indonesia, IMF Policy Discussion Paper, by Enoch, Charles (March 2000).

Financial Sector Crisis and Restructuring Lessons from Asia, by Balino, Tomas J. T., Enoch Charles *et.al* (September 1999).

International Capital Markets: Development, Prospects, and Key Policy Issues (September 1999).

World Economic Outlook, World Economic and Financial Survey (May 1999).

Deposit Insurance: A Survey of Actual and Best Practices, IMF Working Paper 99/54, by Garcia, G (April 1999).

The Korean Financial Crisis of 1997-A Strategy of Financial Sector Reform, IMF Working Paper WP/99/28 by Balino, Tomas J. T. & Ubide, Angel (March 1999).

Credit Allocation and Financial Crisis in Korea, IMF Working Paper WP/99/20 by Borenztein, Eduardo & Lee, Jong-Wha (February 1999).

IMF-Supported Programs in Indonesia, Korea and Thailand. A Preliminary Assessment, IMF Occasional Paper No. 178, by Lane, Timothy *et al.* (1998).

The Determinants of Banking Crises in Developing and Developed Countries, IMF Staff Paper No. 45, by Demirguc-Kunt, Asli & Detragiache E. (1998).

Monetary Policy in Central and Eastern Europe: Lessons after Half a Decade of Transition, IMF Working Paper No. 108, by Begg, David K. H. (1996).

Capital Account Convertibility: Review of Experience and Implications for IMF Policies, IMF Occasional Paper No. 131, by Quirk, Peter J. & Evans, Owen (1995).

Market Discipline, IMF Working Paper WP/92/42 by Lane, Timothy D. (June 1992).

Establishing Incentive Structures and Planning Agencies That Support Market-Oriented Transformations, IMF Working Paper WP/91/113, by Dooley, Michael & Peter, Isard (November 1991).

Soft Budget Constraints, Firm Commitments, and the Social Safety Net, IMF Working Paper WP/91/98, by Hardy, Daniel (October 1991).

Market-Based Fiscal Discipline in Monetary Unions: Evidence from the U.S. Municipal Bond Market, IMF Working Paper WP/91/89, by Goldstein Morris and Woglom, Geoffery (September 1991).

Monetary Policy in an Emerging European Economic and Monetary Union, IMF Staff Papers No. 2, by Frenkel, Jacob A., & Goldstein, Morris (June 1991).

Criteria of External Sustainability, IMF Working Paper WP/88/60, by Horne, Jacelyn (July 1988).

Deposit Insurance: A Survey, IMF mimeo, by McCarthy, I. S. (1979).

CHINA (THE PRC)

Statutes

The Constitution Law of the People's Republic of China (1982, as amended in 1988, 1993 and 1999).

The Contract Law of the People's Republic of China, adopted at the 2nd Session of the 9th NPC on March 15, 1999 and effective as of October 1, 1999.

The Securities Law of the People's Republic of China [*zhonghua renmin gongheguo zhengquan fa*], adopted at the 6th Session of the Standing Committee of the 9th NPC on December 29, 1998, effective as of July 1, 1999.

The Criminal Law of the People's Republic of China [*zhonghua renmin gongheguo xingfa*], adopted at the 2nd Session of the 5th NPC on July 1, 1979, revised at the 5th Session of the 8th NPC on March 14, 1997.

The Security Law of the People's Republic of China, adopted at the 14th Session of the Standing Committee of the 8th NPC on June 30, 1995 and effective as of October 1, 1995.

The Law of the People's Republic of China on the People's Bank of China, adopted at the 3rd Session of the 8th NPC on March 18, 1995, effective as of the same day.

The Law of the People's Republic of China on Commercial Banks, adopted at the 13th Session of the Standing Committee of the 8th NPC on May 10, 1995, and effective as of July 1, 1995.

The Audit Law of the People's Republic of China [*zhonghua renmin gongheguo shenjifa*], adopted at the 9th Session of the Standing Committee of the 8th NPC on August 31, 1994 and effective as of January 1, 1995.

The Company Law of the People's Republic of China, adopted at the 5th Session of the Standing Committee of the 8th NPC on December 29, 1993 and effective as of July 1, 1994 (as amended in 1999).

Law of Civil Procedure of the People's Republic of China [*zhonghua renmin gongheguo minshi susongfa*], adopted by the 4th session of the 7th NPC on April 9, 1991 and effective as of the same day.

The Income Tax Law of the People's Republic of China on Enterprises with Foreign Investment and Foreign Enterprises, adopted in April 1991, effective as of July 1, 1991.

The Law of Bankruptcy for Enterprises of the People's Republic of China (Trial Implementation), adopted by the 18th Session of the 6th NPC on December 2, 1986 and effective as of August 1, 1988.

The Law of the People's Republic of China on State-Owned Industrial Enterprises, adopted at the 1st Session of the 7th NPC, effective as of August 1, 1988.

The State Council:

Regulations on Financial Asset-Management Companies [*jinrong zhichan guanli gongshi tiaoli*], promulgated by the State Council on November 10, 2000 and effective as of the same day.

Procedures of China Securities Regulatory Commission for Examining and Approval Stock Issuance [*zhongguo zhengjianhui gupiao faxing hezhun chengxu*], approved by the State Council on March 16, 2000.

The Promulgation of the Interim Regulations on the Board of Supervisors for State-Owned Enterprises [*gouyou qiye jianshihui zhanxing tiaoli*], promulgated by the State Council on March 15, 2000.

The Interim Regulations on the Board of Supervisors for State-Owned Key Financial Institutions [*guoyou zhongdian jinrong jigou jianshihui zhanxing tiaoli*], promulgated by the State Council on March 15, 2000.

Regulations on Unemployment Insurance, effective as of January 22, 2000.

Decisions of the State Council on Establishing the Basic Medical Insurance System for Urban Employees, issued on December 14, 1998 and effective as of October 1, 1999.

The Proposal of the PBOC, MOF and CSRC on the Establishment of the China Cinda Assets Management Corporation, issued by the General Office of the State Council on April 4, 1999).

Interim Measures on Social Insurance Registration, effective as of March 19, 1999.

Interim Measures on the Administration of Claiming and Payment of Social Insurance, effective as March 19, 1999.

Regulations Concerning the Punishment of Irregular Financial Activities, issued by the State Council on February 22, 1999.

The Interim Provisions on Collecting Social Security Contributions, issued by the State Council on January 22, 1999.

Circular of the General Office of the State Council on Issuing the Report of the PBOC and the SETC on Collecting Bank Interest Arrears According to Law, issued on January 21, 1999.

The Circular of the General Office of the State Council on the Functions, the Internal Structure, and Manning Quotas of the PBOC [*guowuyuan bangongting guanyu yingfa zhongguo renminyinghang zhineng peizhi neishejigou he renyuan bianzhi guiding the tongzhi*], issued by the General Office of the State Council in June 1998.

Interim Provisions on the Board of Supervisors for Solely State-owned Commercial Banks [*guoyou duzi shangye yinhang jianshihui zhanxing guiding*], approved by the State Council on October 20, 1997 and issued by the PBOC on November 12, 1997 (Revealed on March 15, 2000).

Regulations on the PBOC Monetary Policy Committee [*zhongguo renmin yinhang houbi zhengce weiyuanhui tiaoli*], issued by the State Council on April 15, 1997.

- Decisions of the State Council on Establishing a Uniform Basic Endowment Insurance for Workers and Staff Members of Enterprises, issued on July 16, 1997, available in Chinese at *State Council Gazette [Guowuyuan Gongbao]*, No. 28, 1268-1271 (March 20, 1997).
- Circular of the State Council on Issues Related to Adjusting the Tax Policy for the Banking and Insurance Industry, issued by the State Council on February 19, 1997, available in Chinese at *State Council Gazette [Guowuyuan Gongbao]*, No. 6, 229-230 (March 20, 1997).
- Opinion of the PBOC on the Divestiture of the Trust and Investment Companies that Are Subordinate to the Industrial and Commercial and China's Three Other Specialized Banks, endorsed by the State Council in August 1995.
- Circular of the State Council on Establishing State Development Bank, No. 22, 1994, available in Chinese at *State Council Gazette [Guowuyuan Gongbao]*, No. 10, 393-96 (June 1994).
- Circular of the State Council on Establishing China Agricultural Development Bank, No. 25, 1994.
- Circular on the Trial of Bankruptcy of State-owned Enterprises in Several Pilot Cities, issued by the State Council on October 25, 1994.
- Opinions of the PBOC on Enhancing Regulation and Supervision over Financial Institutions [*zhongguo renmin yinhang guanyu jiaqiang jinrong jiaguan gongzhuo yijian de yijian*], approved by the State Council on September 29, 1994.
- The Special Regulations on Limited Stock Companies Issuing Stock and Listing Abroad, issued by the State Council on August 4, 1994.
- Regulations of the People's Republic of China on the Administration of Foreign-invested Financial Institutions [*zhonghua renmin gonghe guo waizi jinrong jigou guanli tiaoli*], issued by the State Council on February 25, 1994 and effective as of April 1, 1994.
- Interim Enterprise Income Tax Regulations of the People's Republic of China, issued by the State Council on December 13, 1993 and effective as of January 1, 1994.
- Resolution on Financial Reform, State Council, No. 91 (1993).
- Interim Regulations of the People's Republic of China on Enterprise Income Tax, adopted by the State Council on December 13, 1993, effective as of January 1, 1994.
- Regulations Governing Deposit and Savings [*chuxu guanli tiaoli*], promulgated by the State Council on December 11, 1992.
- Decisions of the State Council Concerning the Reestablishment of the Bank of Communications, issued on July 24, 1986.
- Interim Regulations of the People's Republic of China on Bank Administration, issued by the State Council on January 7, 1986.
- Report of the PBOC Concerning the Division of Business Scope in Fixed Asset Loans Among Specialized Banks, approved by the State Council on May 13, 1984.

State-operated Enterprises Income Tax Regulations of the People's Republic of China (draft), issued by the State Council on September 18, 1984 and effective from October 1, 1984 to January 1, 1994.

Decisions of the State Council on the PBOC's Exclusive Role as Central Bank, issued by the State Council on September 17, 1983.

Circular of the State Council Approving and Promulgating the Report of the People's Bank of China on PBOC's Unified-management of State-operated Enterprises' Working Capital, issued by the State Council on June 25, 1983.

Reply of the State Council to the PBOC's Proposal Concerning the Amendments to the BOC's Articles of Association. Issued by the State Council on September 22, 1980.

Decision of the State Council on Establishing the People's Construction Bank of China, issued by the State Council on September 9, 1954.

The Ministry of Finance:

Accounting Standards for Enterprises, issued by the Ministry of Finance on November 30, 1992 and effective as of July 1, 1993.

Circular Revising Interim Provisions on State Specialized Banks' Irrecoverable Loan Reserves, issued by the Ministry of Finance and effective as of January 1, 1992.

Interim Provisions on State Specialized Banks' Irrecoverable Loan Reserves, issued by the Ministry of Finance and effective as of January 1, 1988 (as amended in 1992).

Interim Provisions Converting All State Budgetary Capital Construction Investment from Appropriations to Loans, adopted by the Ministry of Finance on December 14, 1984.

The People's Bank of China (PBOC):

Regulations on Administration of Trust and Investment Companies, issued on January 19, 2001.

Measures for Using Stocks as Collateral for Loans, issued by the PBOC and the CSRC on February 13, 2000.

Regulations on Fund-Management Companies and Securities Companies in the Inter-bank Market, promulgated on August 19, 1999.

Interim Measures Governing Closed-End Loans [*Fengbi Daikuan Guanli Zhanxing Banfa*], issued jointly by the PBOC, the Ministry of Finance, the SETC, the State Tax Bureau and the State Development Planning Commission on July 26, 1999.

Guidelines on External Audit for Foreign-Invested Banks [*waizi yinhang waibu shenji zhidao yijian*], issued by the PBOC in May 1999.

- Regulations of the PBOC on Financial Supervisory Responsibilities (for Trial Purpose) [*Zhongguo Renmin Yinhang Jinrong Jianguan Zerenzhi (zhaixing)*], issued by the PBOC on April 24, 1999.
- Interim Guidelines for Commercial Banks Setting Uniform Exposure Limits [*shangye yinhang shishis tongyi shouxin zhidu zhiying (shixing)*], issued by the PBOC on January 20, 1999 and effective as of the same day.
- Guidelines of the PBOC on Ameliorate Financial Service to Support Economic Development (1998).
- Guidelines for Loan Classification (1998 No. 151)
- Notice Concerning Further Supporting State-owned Industrial Enterprises that Are Losing Money which Have Saleable and Efficiently Produced Products [*Guanyu Jingyibu Zhichi Guoyou Kuisun Gongye Qiye youxiaolu, youxiaoyi Chanpin Shengchan de Tongzhi*], issued jointly by the PBOC, State Economic and Trade Commission, State Bureau of Taxation, in June 1998.
- Circular on Issues Concerning Loan Management [*guanyu jinyibu jiaqiang daikuan guanli youguan wenti de tongzhi*], issued by the PBOC January 12, 1998.
- Circular of the PBOC on Issuing Forms of Off-site Surveillance Reports for Commercial Banks and Their Description [*zhongguo renmin yinhang guanyu yinfa shangye yinhang feixianchang jianguan zhibiao baobiao tianbao shouming he shangye yinhang feixianchang jianguan baobiao baogaoshu de tongzhi*], issued by the PBOC on December 16, 1997 and effective as of January 1, 1998.
- Circular on Improving the Loan Size Management for State Commercial Banks [*zhongguo renmin yinhang guanyu gaijing guoyou shangye yinhang daikuan guimo guili de tongzhi*] (December 24, 1997).
- Interim Provisions on the Board of Supervisors for Solely State-owned Commercial Banks [*guoyou duzi shangye yinhang jianshihui zhanxing guiding*], approved by the State Council on October 20, 1997 and issued by the PBOC on November 12, 1997.
- Interim Provisions Concerning the Supervisory Board for Sole State-owned Commercial Banks, approved by the State Council on October 20, 1997 (November 12, 1997).
- Provisions on Enhancing Internal Controls on Banking Accounting (July 31, 1997).
- Provisions on Enhancing Internal Accounting Controls and Management in Banks [*jing yi bu jiaqiang yinhang kuiji neibu kongzhi he guanli de ruogan guiding*], issued by the PBOC on July 30, 1997.
- Guidelines of the PBOC for Enhancing Internal Controls of Financial Institutions [*zhongguo renmin yinhang jiaqiang jinrong jiguo neibu kongzhi de zhidao yuanze*], issued by the PBOC on May 16, 1997.
- Monitoring and Supervisory Indexes of Asset-Liability Ratio Management for Commercial Banks [*shangye yinhang zhichan fuzhai bili guanli jiankong, jianche zhibiao*], issued by the PBOC on December 12, 1996 and effective as of January 1, 1997.

- Measures on Examining Asset-Liability Ratio Management for Commercial Banks [*shangye yinhang zhichan fuzhai bili guanli kaohe banfa*], issued by the PBOC on December 12, 1996 and effective as of January 1, 1997.
- Interim Management Measures of the Scope of Authority of Commercial Bank Functional Departments and Branches [*shangye yinhang shouquan, shouxin guanli zhanxing banfa*], issued by the PBOC on November 11, 1996.
- Interim Provisions on the Administration of Qualifications for Financial Institution Senior Management [*jinrong jigou gaoji guanli ren yuan renzhi zhige guanli zhanxing guiding*], issued by the PBOC on September 13, 1996.
- Interim Measures for Main Bank Management, issued by the PBOC on June 29, 1996, effective as of July 1, 1996.
- General Lending Rules [*daikuan tongze*], published by the PBOC on June 28, 1996 and effective as of August 1, 1996.
- Circular of the PBOC on Issues Concerning Recommended Accounting Firms [*zhongguo renmin yinhang guanyu tongyi tuijian kuiji (shenji) shi shiwushuo youguan wenti de tongzhi*], issued by the PBOC on March 15, 1996.
- Circular of the PBOC on Collecting Financial Statements from Banks for Supervisory Purpose [*zhongguo renmin yinhang guanyu yinhangye jianguan baobiao shixing zhuangshou zhidu de tongzhi*], issued by the PBOC on March 6, 1996.
- Circular of the PBOC on Issuing Interim Provisions on Off-site Surveillance [*zhongguo renmin yinhang guanyu yinfa feixianchang jihe jiandu zhanxing guiding de tongzhi*], issued by the PBOC on April 5, 1995.
- Urgent Circular on Making Working Capital Loans to SOEs, PBOC No. 34 (1994).
- Provisions on Financial Institution Administration [*jinrong jigou guanli guiding*], promulgated by the PBOC on August 5, 1994.
- Provisional Regulations Concerning Investment in Financial Institutions through Purchase of Shares, promulgated by the PBOC on 28th July 1994.
- Provisional Measures on Commercial Banks' Asset: Liability Ratio Management, issued on February 18, 1994.
- Circular of the PBOC Concerning the Asset-Liability Management of Commercial Banks, issued on February 15, 1994.
- Interim Measures Governing the PBOC Lending to Financial Institutions [*zhongguo renmin yinhang dui jinrong jigou daikuan guanli zhanxing bangfa*], issued by the PBOC on March 3, 1993.
- Interim Provisions on Interest Rate Administration [*lilv guanli zhanxing guiding*], issued by the PBOC in December 1990.

The Supreme People's Court:

Provisions of the Supreme People's Court on the Application of Law Concerning Financial Asset Management Companies in Their Purchasing, Managing and Handling of State Banks' Non-performing Loans [zuigao renming fayuan guanyu shenli jinrong zhichan guanli gongsi shougou, guanli, chuzhi guoyou yinghang buliang diakuan xingcheng de zhichan de anjian shiyong falv ruogan wenti de guiding], adopted by the Supreme People's Court Judicial Committee at its No. 1167 meeting on April 3, 2001, published by the Supreme People's Court on April 11, 2001 and effective as of April 23, 2001.

Opinions of the Supreme People's Court on Issues Concerning the Implementation of the Law of Bankruptcy for Enterprises of the People's Republic of China, promulgated on November 7, 1991.

The Communist Party of China:

Decisions on Issues Related to State-owned Enterprise Reforms and Development, adopted at the 15th Central Committee of the Communist Party of China in September, 1999

Hold High the Great Banner of Deng Xiaoping Theory for an All-Round Advancement of the Cause of Building Socialism with Chinese Characteristics to the 21st Century- Extracts from the report delivered by Jian Zhemin at the Fifteenth National Congress of the Communist Party of China on September 12, 1997, *People's Daily*, 2 (September 13, 1997).

Decisions of the CPC Central Committee on Issues Concerning the Establishment of the Socialist Market Economy System, *Beijing: Xinhua Monthly*, 6 (November 1993).

The Communiqué of the Fourteenth National Congress of the Communist Party of China, in *Official Documents of the Fourteenth National Congress of the Communist Party of China*, 22 (Beijing: 1992).

Jiang Zemin's address at the 14th National Congress of the CPC, *People's Daily*, 2 (October 13, 1992).

Others

Decisions on Greatly Developing the Individual and Private Economy, issued jointly by the Guangdong Provincial Committee of the Communist Party of China and Guangdong Provincial People's Government in September 1999.

The Interim Rules on Management of State-Owned Assets in the Pilot Enterprises of Joint Stock System [gufenzhi shidian qiye guoyou zichan guanli zaixing guiding], issued by State Assets Administration and State Economic Restructuring Commission on July 27, 1992.

The Interim Measures Concerning the Sale of Small-Sized State-Owned Enterprises, issued jointly by the State Commission for Economic Restructuring, the Ministry of Finance and the State Administration of State Property on February 19, 1989.

THE WORLD BANK

Designing a Bank Safety Net — A Long-term Perspective, World Bank Mimeo 1999, by Demirguc-Kunt, Asli available at 'http://www1.worldbank.org/finance/html/designing_a_bank_sn.html'.

Designing Financial Safety Nets to Fit Country Circumstances: A Progress Report, World Bank Mimeo, by Kane, E., 1999.

Global Economic Prospects 2000 Report (December 1999).

Financial Restructuring in East Asia: Halfway There? The World Bank Financial Sector Discussion Paper No. 3, by Stijin Claessens, Simeon Djankow, and Daniela Klingebiel (September 1999).

Financial Services and the World Trade Organization: Liberalization Commitments of the Developing and Transitional Economies, World Bank memo, by Matto, Asditya (1999).

Financial Services and the WTO: Liberalization in the Developing and Transition Economies, the World Bank Staff Working Paper TISD9803.WPF, by Matto, Asditya (March, 1998).

China 2020: Development Challenges in the New Century, the World Bank China 2020 Series (September 1997).

China: Reform of State-Owned Enterprises, Report 14924-CHA (1996).

The Chinese Economy: Fighting Inflation, Deepening Reforms, A World Bank Country Study (1996).

China: Pension System Reform, A World Bank Country Study (1996).

From Plan to Market (1996).

The Polish Experience in Bank and Enterprise Restructuring, by Fernando Montes-Negret & Papi, Luca (November 1996).

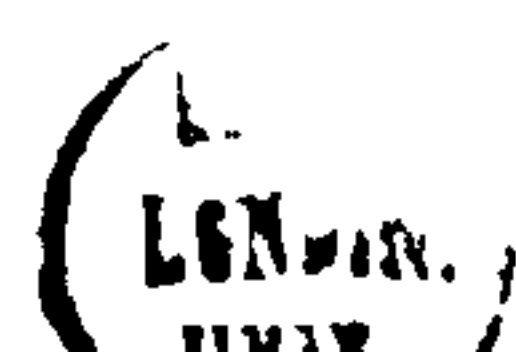
Bank-Led Restructuring in Poland (II): Bankruptcy and Its Alternatives, by Gray, Cheryl W. & Holle, Arnold (September 1996).

Bank-Led Restructuring in Poland (I): An Empirical Look at the Bank Conciliation Process, by Gray, Cheryl W. & Holle, Arnold (September 1996).

Restructuring Banks and Enterprises: Recent Lessons from Transition Countries, Discussion Paper No. 279, by Borish Michael S., Long, Millard F. & Noel, Michel (1995).

The Role of Commercial Banks in Enterprise Restructuring in Central and Eastern Europe, A World Bank Policy Research Working Paper, by Long, Millard & Rutkowska Izabela (February 1995).

Deposit Insurance in Developing Countries, World Bank Policy Research and External Affairs Working Paper WPS 548, by Talley, S. H. & Mas, I. (1990).



China: Financial Sector Policies and Institutional Development, a World Bank Country Study (1990).

World Development Report (1989).

China: Finance and Development (1988).

Case Study: Adjustment and Reform in the Chongqing Clock and Watch Company, World Bank Staff Working Papers, by Byrd, William & Tidrick, Gene (April 1984).

THE WORLD TRADE ORGANIZATION (GATT)

Whether and When to Liberalize Capital Account and Financial Services, WTO Staff Working Paper ERAD-99-03, by Williamson, John (September, 1999).

